Current Liabilities and Contingencies

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Describe the nature, type, and valuation of current liabilities.
2. Explain the classification issues of short-term debt expected to be refinanced.
3. Identify types of employee-related liabilities.
4. Identify the criteria used to account for and disclose gain and loss contingencies.
5. Explain the accounting for different types of loss contingencies.
6. Indicate how to present and analyze liabilities and contingencies.

Now You See It, Now You Don’t

A look at the liabilities side of the balance sheet of the company Beru AG Corporation, dated March 31, 2003, shows how international standards have changed regarding the reporting of financial information. Here is how one liability was shown on this date:

Anticipated losses arising from pending transactions 3,285,000 euros

Do you believe a liability should be reported for such transactions? Anticipated losses means the losses have not yet occurred; pending transactions mean that the condition that might cause the loss has also not occurred. So where is the liability? To whom does the company owe something? Where is the obligation?

German accounting rules in 2003 were permissive. They allowed companies to report liabilities for possible future events. In essence, the establishment of this general-purpose “liability” provides a buffer for Beru if losses do materialize. If you take a more skeptical view, you might say the accounting rules let Beru smooth its income by charging expenses in good years and reducing expenses in bad years.

The story has a happy ending: European companies switched to International Financial Reporting Standards (IFRS) in 2005. Under IFRS, liabilities like “Anticipated losses arising from pending transactions” disappear. So when we look at Beru’s 2005 financial statements, we find a note stating that the company has reported as liabilities only obligations arising from past transactions that can be reasonably estimated.

Standard-setters continue to work on the financial reporting of certain “contingent” liabilities, such as those related to pending lawsuits and other possible losses for which a company might be liable. As you will learn in this chapter, standard-setters have provided much more transparency in reporting liability-type transactions. However, much still needs to be done. For example, the IASB is considering major changes in how to recognize and measure contingent liabilities. The task will not be easy.

Consider a simple illustration involving a company that sells hamburgers:

- The hamburgers are sold in a jurisdiction where the law states that the seller must pay $100,000 to each customer that purchases a contaminated hamburger;
- At the end of the reporting period, the company has sold one hamburger; and
- Past experience indicates there is a one in a million chance that a hamburger sold by the entity is contaminated. No other information is available.
Does the company have a liability? What is the conceptual justification, if any, to record a liability or for that matter, not to record a liability? And if you conclude that the sale of the hamburger results in a liability, how do you measure it? Another way to ask the question is whether the hamburger issue is a recognition issue or a measurement issue. This example illustrates some of the difficult questions that the IASB faces in this area.

The FASB recently proposed expanded disclosure about the nature of contingencies, more quantitative and qualitative background on contingencies, and, maybe most welcome of all, required tabular presentation of the changes in contingencies, including explanation of the changes. Note that these disclosures are similar to those required in IFRS. What’s not to like about these enhanced disclosures? Well quite a bit, according to early responses by some companies and the legal profession. These parties are concerned that the information in these enhanced disclosures could be used against them in a lawsuit, and they are voicing strong opposition to the proposed rules. We do not know the end of this liability story. However, the controversy over the proposed rules illustrates the challenges of developing accounting rules for liabilities that meet the needs of investors while avoiding harm to the companies reporting the information.

As our opening story indicates, the convergence of GAAP and IFRS should lead to improved reporting of liabilities. In this chapter, we explain the basic issues related to accounting and reporting for current and contingent liabilities. The content and organization of the chapter are as follows.
SECTION 1 • CURRENT LIABILITIES

WHAT IS A LIABILITY?

The question, “What is a liability?” is not easy to answer. For example, is preferred stock a liability or an ownership claim? The first reaction is to say that preferred stock is in fact an ownership claim, and companies should report it as part of stockholders’ equity. In fact, preferred stock has many elements of debt as well. The issuer (and in some cases the holder) often has the right to call the stock within a specific period of time—making it similar to a repayment of principal. The dividend on the preferred stock is in many cases almost guaranteed (the cumulative provision)—making it look like interest. As a result, preferred stock is but one of many financial instruments that are difficult to classify.\(^1\)

To help resolve some of these controversies, the FASB, as part of its conceptual framework, defined liabilities as “probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.”\(^2\) In other words, a liability has three essential characteristics:

1. It is a present obligation that entails settlement by probable future transfer or use of cash, goods, or services.
2. It is an unavoidable obligation.
3. The transaction or other event creating the obligation has already occurred.

Because liabilities involve future disbursements of assets or services, one of their most important features is the date on which they are payable. A company must satisfy maturing obligations in the ordinary course of business to continue operating. Liabilities with a more distant due date do not, as a rule, represent a claim on the company’s current resources. They are therefore in a slightly different category. This feature gives rise to the basic division of liabilities into (1) current liabilities and (2) long-term debt.

WHAT IS A CURRENT LIABILITY?

Recall that current assets are cash or other assets that companies reasonably expect to convert into cash, sell, or consume in operations within a single operating cycle or within a year (if completing more than one cycle each year). Current liabilities are “obligations whose liquidation is reasonably expected to require use of existing resources properly classified as current assets, or the creation of other current liabilities.”\(^2\) This definition has gained wide acceptance because it recognizes operating cycles of varying lengths in different industries. This definition also considers the important relationship between current assets and current liabilities.\(^3\)

---

\(^1\)This illustration is not just a theoretical exercise. In practice, a number of preferred stock issues have all the characteristics of a debt instrument, except that they are called and legally classified as preferred stock. In some cases, the IRS has even permitted companies to treat the dividend payments as interest expense for tax purposes.

\(^2\)The FASB has issued a standard to address the accounting for some of these securities and is working on a broader project to address the accounting for securities with debt and equity features. See http://www.fasb.org/project/ liaeq.shtml.

The **operating cycle** is the period of time elapsing between the acquisition of goods and services involved in the manufacturing process and the final cash realization resulting from sales and subsequent collections. Industries that manufacture products requiring an aging process, and certain capital-intensive industries, have an operating cycle of considerably more than one year. On the other hand, most retail and service establishments have several operating cycles within a year.

Here are some typical current liabilities:

1. Accounts payable.
2. Notes payable.
4. Short-term obligations expected to be refinanced.
5. Dividends payable.
6. Customer advances and deposits.
7. Unearned revenues.
8. Sales taxes payable.
9. Income taxes payable.
10. Employee-related liabilities.

**Accounts Payable**

Accounts payable, or **trade accounts payable**, are balances owed to others for goods, supplies, or services purchased on open account. Accounts payable arise because of the time lag between the receipt of services or acquisition of title to assets and the payment for them. The terms of the sale (e.g., 2/10, n/30 or 1/10, E.O.M.) usually state this period of extended credit, commonly 30 to 60 days.

Most companies record liabilities for purchases of goods upon receipt of the goods. If title has passed to the purchaser before receipt of the goods, the company should record the transaction at the time of title passage. A company must pay special attention to transactions occurring near the end of one accounting period and at the beginning of the next. It needs to ascertain that the record of goods received (the inventory) agrees with the liability (accounts payable), and that it records both in the proper period.

Measuring the amount of an account payable poses no particular difficulty. The invoice received from the creditor specifies the due date and the exact outlay in money that is necessary to settle the account. The only calculation that may be necessary concerns the amount of cash discount. See Chapter 8 for illustrations of entries related to accounts payable and purchase discounts.

**Notes Payable**

**Notes payable** are written promises to pay a certain sum of money on a specified future date. They may arise from purchases, financing, or other transactions. Some industries require notes (often referred to as **trade notes payable**) as part of the sales/purchases transaction in lieu of the normal extension of open account credit. Notes payable to banks or loan companies generally arise from cash loans. Companies classify notes as short-term or long-term, depending on the payment due date. Notes may also be interest-bearing or zero-interest-bearing.

**Interest-Bearing Note Issued**

Assume that Castle National Bank agrees to lend $100,000 on March 1, 2012, to Landscape Co. if Landscape signs a $100,000, 6 percent, four-month note. Landscape records the cash received on March 1 as follows.

<table>
<thead>
<tr>
<th>March 1</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>100,000</td>
</tr>
<tr>
<td>Notes Payable</td>
<td>100,000</td>
</tr>
</tbody>
</table>

(To record issuance of 6%, 4-month note to Castle National Bank)
Chapter 13 Current Liabilities and Contingencies

If Landscape prepares financial statements semiannually, it makes the following adjusting entry to recognize interest expense and interest payable of $2,000 ($100,000 × 6% × 4/12) at June 30.

**June 30**

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense</td>
<td>2,000</td>
<td></td>
</tr>
<tr>
<td>Interest Payable</td>
<td></td>
<td>2,000</td>
</tr>
</tbody>
</table>

(To accrue interest for 4 months on Castle National Bank note)

If Landscape prepares financial statements monthly, its adjusting entry at the end of each month is $500 ($100,000 × 6% × 1/12).

At maturity (July 1), Landscape must pay the face value of the note ($100,000) plus $2,000 interest ($100,000 × 6% × 4/12). Landscape records payment of the note and accrued interest as follows.

**July 1**

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notes Payable</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Interest Payable</td>
<td>2,000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>102,000</td>
<td></td>
</tr>
</tbody>
</table>

(To record payment of Castle National Bank interest-bearing note and accrued interest at maturity)

**Zero-Interest-Bearing Note Issued**

A company may issue a zero-interest-bearing note instead of an interest-bearing note. A zero-interest-bearing note does not explicitly state an interest rate on the face of the note. Interest is still charged, however. At maturity the borrower must pay back an amount greater than the cash received at the issuance date. In other words, the borrower receives in cash the present value of the note at maturity minus the interest or discount charged by the lender for the term of the note. In essence, the bank takes its fee “up front” rather than on the date the note matures.

To illustrate, assume that Landscape issues a $102,000, four-month, zero-interest-bearing note to Castle National Bank. The present value of the note is $100,000. Landscape records this transaction as follows.

**March 1**

<table>
<thead>
<tr>
<th>Account</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>Discount on Notes Payable</td>
<td>2,000</td>
<td></td>
</tr>
<tr>
<td>Notes Payable</td>
<td>102,000</td>
<td></td>
</tr>
</tbody>
</table>

(To record issuance of 4-month, zero-interest-bearing note to Castle National Bank)

Landscape credits the Notes Payable account for the face value of the note, which is $2,000 more than the actual cash received. It debits the difference between the cash received and the face value of the note to Discount on Notes Payable. Discount on Notes Payable is a contra account to Notes Payable, and therefore is subtracted from Notes Payable on the balance sheet. Illustration 13-1 shows the balance sheet presentation on March 1.

**ILLUSTRATION 13-1**
Balance Sheet Presentation of Discount

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current liabilities</td>
<td></td>
</tr>
<tr>
<td>Notes payable</td>
<td>$102,000</td>
</tr>
<tr>
<td>Less: Discount on notes payable</td>
<td>2,000</td>
</tr>
<tr>
<td></td>
<td>$100,000</td>
</tr>
</tbody>
</table>

The amount of the discount, $2,000 in this case, represents the cost of borrowing $100,000 for 4 months. Accordingly, Landscape charges the discount to interest expense.

---

4The bank discount rate used in this example to find the present value is 5.96 percent.
What Is a Current Liability? 725

over the life of the note. That is, the Discount on Notes Payable balance represents interest expense chargeable to future periods. Thus, Landscape should not debit Interest Expense for $2,000 at the time of obtaining the loan. We discuss additional accounting issues related to notes payable in Chapter 14.

Current Maturities of Long-Term Debt

PepsiCo reports as part of its current liabilities the portion of bonds, mortgage notes, and other long-term indebtedness that matures within the next fiscal year. It categorizes this amount as current maturities of long-term debt. Companies, like PepsiCo, exclude long-term debts maturing currently as current liabilities if they are to be:

1. Retired by assets accumulated for this purpose that properly have not been shown as current assets,
2. Refinanced, or retired from the proceeds of a new debt issue, or
3. Converted into capital stock.

In these situations, the use of current assets or the creation of other current liabilities does not occur. Therefore, classification as a current liability is inappropriate. A company should disclose the plan for liquidation of such a debt either parenthetically or by a note to the financial statements. When only a part of a long-term debt is to be paid within the next 12 months, as in the case of serial bonds that it retires through a series of annual installments, the company reports the maturing portion of long-term debt as a current liability, and the remaining portion as a long-term debt.

However, a company should classify as current any liability that is due on demand (callable by the creditor) or will be due on demand within a year (or operating cycle, if longer). Liabilities often become callable by the creditor when there is a violation of the debt agreement. For example, most debt agreements specify a given level of equity to debt be maintained, or specify that working capital be of a minimum amount. If the company violates an agreement, it must classify the debt as current because it is a reasonable expectation that existing working capital will be used to satisfy the debt. Only if a company can show that it is probable that it will cure (satisfy) the violation within the grace period specified in the agreements can it classify the debt as noncurrent. [4]

Short-Term Obligations Expected to Be Refinanced

Short-term obligations are debts scheduled to mature within one year after the date of a company’s balance sheet or within its operating cycle, whichever is longer. Some short-term obligations are expected to be refinanced on a long-term basis. These short-term obligations will not require the use of working capital during the next year (or operating cycle).5

At one time, the accounting profession generally supported the exclusion of short-term obligations from current liabilities if they were “expected to be refinanced.” But the profession provided no specific guidelines, so companies determined whether a short-term obligation was “expected to be refinanced” based solely on management’s intent to refinance on a long-term basis. Classification was not clear-cut. For example, a company might obtain a five-year bank loan but handle the actual financing with 90-day notes, which it must keep turning over (renewing). In this case, is the loan a long-term debt or a current liability? Another example was the Penn Central Railroad

5Refinancing a short-term obligation on a long-term basis means either replacing it with a long-term obligation or equity securities, or renewing, extending, or replacing it with short-term obligations for an uninterrupted period extending beyond one year (or the operating cycle, if longer) from the date of the enterprise’s balance sheet.
726 Chapter 13 Current Liabilities and Contingencies

before it went bankrupt. The railroad was deep into short-term debt but classified it as long-term debt. Why? Because the railroad believed it had commitments from lenders to keep refinancing the short-term debt. When those commitments suddenly disappeared, it was “good-bye Pennsy.” As the Greek philosopher Epictetus once said, “Some things in this world are not and yet appear to be.”

Refinancing Criteria

To resolve these classification problems, the accounting profession has developed authoritative criteria for determining the circumstances under which short-term obligations may be properly excluded from current liabilities. A company is required to exclude a short-term obligation from current liabilities if both of the following conditions are met:

1. It must intend to refinance the obligation on a long-term basis.
2. It must demonstrate an ability to consummate the refinancing. [5]

Intention to refinance on a long-term basis means that the company intends to refinance the short-term obligation so that it will not require the use of working capital during the ensuing fiscal year (or operating cycle, if longer).

The company demonstrates the ability to consummate the refinancing by:

(a) Actually refinancing the short-term obligation by issuing a long-term obligation or equity securities after the date of the balance sheet but before it is issued; or
(b) Entering into a financing agreement that clearly permits the company to refinance the debt on a long-term basis on terms that are readily determinable.

If an actual refinancing occurs, the portion of the short-term obligation to be excluded from current liabilities may not exceed the proceeds from the new obligation or equity securities used to retire the short-term obligation. For example, Montavon Winery had $3,000,000 of short-term debt. Subsequent to the balance sheet date, but before issuing the balance sheet, the company issued 100,000 shares of common stock, intending to use the proceeds to liquidate the short-term debt at its maturity. If Montavon’s net proceeds from the sale of the 100,000 shares total $2,000,000, it can exclude from current liabilities only $2,000,000 of the short-term debt.

An additional question is whether a company should exclude from current liabilities a short-term obligation if it is paid off after the balance sheet date and replaced by long-term debt before the balance sheet is issued. To illustrate, Marquardt Company pays off short-term debt of $40,000 on January 17, 2013, and issues long-term debt of $100,000 on February 3, 2013. Marquardt’s financial statements, dated December 31, 2012, are to be issued March 1, 2013. Should Marquardt exclude the $40,000 short-term debt from current liabilities? No—here’s why: Repayment of the short-term obligation required the use of existing current assets before the company obtained funds through long-term financing. Therefore, Marquardt must include the short-term obligations in current liabilities at the balance sheet date (see graphical presentation below).
WHAT ABOUT THAT SHORT-TERM DEBT?

The evaluation of credit quality involves more than simply assessing a company’s ability to repay loans. Credit analysts also evaluate debt management strategies. Analysts and investors will reward what they view as prudent management decisions with lower debt service costs and a higher stock price. The wrong decisions can bring higher debt costs and lower stock prices.

General Electric Capital Corp., a subsidiary of General Electric, experienced the negative effects of market scrutiny of its debt management policies. Analysts complained that GE had been slow to refinance its mountains of short-term debt. GE had issued these current obligations, with maturities of 270 days or less, when interest rates were low. However, in light of expectations that the Fed would raise interest rates, analysts began to worry about the higher interest costs GE would pay when it refinanced these loans. Some analysts recommended that it was time to reduce dependence on short-term credit. The reasoning goes that a shift to more dependable long-term debt, thereby locking in slightly higher rates for the long-term, is the better way to go.

Thus, scrutiny of GE debt strategies led to analysts’ concerns about GE’s earnings prospects. Investors took the analysis to heart, and GE experienced a 2-day 6 percent drop in its stock price.


Dividends Payable

A cash dividend payable is an amount owed by a corporation to its stockholders as a result of board of directors’ authorization. At the date of declaration, the corporation assumes a liability that places the stockholders in the position of creditors in the amount of dividends declared. Because companies always pay cash dividends within one year of declaration (generally within three months), they classify them as current liabilities.

On the other hand, companies do not recognize accumulated but undeclared dividends on cumulative preferred stock as a liability. Why? Because preferred dividends in arrears are not an obligation until the board of directors authorizes the payment. Nevertheless, companies should disclose the amount of cumulative dividends unpaid in a note, or show it parenthetically in the capital stock section.

Dividends payable in the form of additional shares of stock are not recognized as a liability. Such stock dividends (as we discuss in Chapter 15) do not require future outlays of assets or services. Companies generally report such undistributed stock dividends in the stockholders’ equity section because they represent retained earnings in the process of transfer to paid-in capital.

Customer Advances and Deposits

Current liabilities may include returnable cash deposits received from customers and employees. Companies may receive deposits from customers to guarantee performance of a contract or service or as guarantees to cover payment of expected future obligations. For example, a company like Alltel Corp. often requires a deposit on equipment that customers use to connect to the Internet or to access its other services. Alltel also may receive deposits from customers as guarantees for possible damage to property. Additionally, some companies require their employees to make deposits for the return of keys or other company property.
Chapter 13 Current Liabilities and Contingencies

The classification of these items as current or noncurrent liabilities depends on the time between the date of the deposit and the termination of the relationship that required the deposit.

Unearned Revenues

A magazine publisher, such as Golf Digest, receives payment when a customer subscribes to its magazines. An airline company, such as American Airlines, sells tickets for future flights. And software companies, like Microsoft, issue coupons that allow customers to upgrade to the next version of their software. How do these companies account for unearned revenues that they receive before delivering goods or rendering services?

1. Upon receipt of the advance, debit Cash, and credit a current liability account identifying the source of the unearned revenue.
2. Upon earning the revenue, debit the unearned revenue account, and credit an earned revenue account.

To illustrate, assume that Allstate University sells 10,000 season football tickets at $50 each for its five-game home schedule. Allstate University records the sales of season tickets as follows.

August 6
Cash 500,000
Unearned Sales Revenue 500,000
(To record sale of 10,000 season tickets)

After each game, Allstate University makes the following entry.

September 7
Unearned Sales Revenue 100,000
Sales Revenue 100,000
(To record football ticket revenues earned)

Unearned Sales Revenue is, therefore, unearned revenue. Allstate University reports it as a current liability in the balance sheet. As revenue is earned, a transfer from unearned revenue to earned revenue occurs. Unearned revenue is material for some companies: In the airline industry, tickets sold for future flights represent almost 50 percent of total current liabilities.

Illustration 13-3 shows specific unearned and earned revenue accounts used in elected types of businesses.

The balance sheet should report obligations for any commitments that are redeemable in goods and services. The income statement should report revenues earned during the period.
What Is a Current Liability? 729

MICROSOFT’S LIABILITIES—GOOD OR BAD?

Users of financial statements generally examine current liabilities to assess a company’s liquidity and overall financial flexibility. Companies must pay many current liabilities, such as accounts payable, wages payable, and taxes payable, sooner rather than later. A substantial increase in these liabilities should raise a red flag about a company’s financial position.

This is not the case for all current liabilities. For example, Microsoft has a current liability entitled “Unearned revenue” of $14,830 million in 2010 that has increased year after year. Unearned revenue is a liability that arises from sales of Microsoft products such as Internet Explorer and Windows XP. Microsoft also has provided coupons for upgrades to its programs to bolster sales of its XBox consoles. At the time of a sale, customers pay not only for the current version of the software but also for future upgrades. Microsoft recognizes sales revenue from the current version of the software and records as a liability (unearned revenue) the value of future upgrades to the software that it “owes” to customers.

Market analysts read such an increase in unearned revenue as a positive signal about Microsoft’s sales and profitability. When Microsoft’s sales are growing, its unearned revenue account increases. Thus, an increase in a liability is good news about Microsoft sales. At the same time, a decline in unearned revenue is bad news. As one analyst noted, a slowdown or reversal of the growth in Microsoft’s unearned revenues indicates slowing sales, which is bad news for investors. Thus, increases in current liabilities can sometimes be viewed as good signs instead of bad.


Sales Taxes Payable

Retailers like Wal-Mart, Best Buy, and GAP must collect sales taxes from customers on transfers of tangible personal property and on certain services and then must remit these taxes to the proper governmental authority. GAP, for example, sets up a liability to provide for taxes collected from customers but not yet remitted to the tax authority. The Sales Taxes Payable account should reflect the liability for sales taxes due various governments.

The entry below illustrates use of the Sales Taxes Payable account on a sale of $3,000 when a 4 percent sales tax is in effect.

<table>
<thead>
<tr>
<th>Cash</th>
<th>3,120</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Revenue</td>
<td>3,000</td>
</tr>
<tr>
<td>Sales Taxes Payable</td>
<td>120</td>
</tr>
</tbody>
</table>

Sometimes the sales tax collections credited to the liability account are not equal to the liability as computed by the governmental formula. In such a case, GAP makes an adjustment of the liability account by recognizing a gain or a loss on sales tax collections.

Many companies do not segregate the sales tax and the amount of the sale at the time of sale. Instead, the company credits both amounts in total in the Sales Revenue account. Then, to reflect correctly the actual amount of sales and the liability for sales taxes, the company would debit the Sales Revenue account for the amount of the sales taxes due the government on these sales, and would credit the Sales Taxes Payable account for the same amount.

To illustrate, assume that the Sales Revenue account balance of $150,000 includes sales taxes of 4 percent. Thus, the amount recorded in the Sales Revenue account is comprised of the sales amount plus sales tax of 4 percent of the sales amount. Sales therefore are $144,230.77 ($150,000 ÷ 1.04) and the sales tax liability is $5,769.23 ($144,230.77 × 0.04; or $150,000 – $144,230.77). The following entry would record the amount due the taxing unit.

Sales Revenue      5,769.23
Sales Taxes Payable 5,769.23
Chapter 13 Current Liabilities and Contingencies

Income Taxes Payable

Any federal or state income tax varies in proportion to the amount of annual income. Using the best information and advice available, a business must prepare an income tax return and compute the income tax payable resulting from the operations of the current period. Corporations should classify as a current liability the taxes payable on net income, as computed per the tax return. Unlike a corporation, proprietorships and partnerships are not taxable entities. Because the individual proprietor and the members of a partnership are subject to personal income taxes on their share of the business’s taxable income, income tax liabilities do not appear on the financial statements of proprietorships and partnerships.

Most corporations must make periodic tax payments throughout the year in an authorized bank depository or a Federal Reserve Bank. These payments are based upon estimates of the total annual tax liability. As the estimated total tax liability changes, the periodic contributions also change. If in a later year the taxing authority assesses an additional tax on the income of an earlier year, the company should credit Income Taxes Payable and charge the related debit to current operations.

Differences between taxable income under the tax laws and accounting income under generally accepted accounting principles sometimes occur. Because of these differences, the amount of income tax payable to the government in any given year may differ substantially from income tax expense as reported on the financial statements. Chapter 19 is devoted solely to income tax matters and presents an extensive discussion of this complex topic.

Employee-Related Liabilities

Companies also report as a current liability amounts owed to employees for salaries or wages at the end of an accounting period. In addition, they often also report as current liabilities the following items related to employee compensation.

1. Payroll deductions.
2. Compensated absences.

Payroll Deductions

The most common types of payroll deductions are taxes, insurance premiums, employee savings, and union dues. To the extent that a company has not remitted the amounts deducted to the proper authority at the end of the accounting period, it should recognize them as current liabilities.

Social Security Taxes. Since January 1, 1937, Social Security legislation has provided federal Old Age, Survivor, and Disability Insurance (OASDI) benefits for certain individuals and their families. Funds for these payments come from taxes levied on both the employer and the employee. Employers collect the employee’s share of this tax by deducting it from the employee’s gross pay, and remit it to the government along with their share. The government taxes both the employer and the employee at the same rate, currently 6.2 percent based on the employee’s gross pay up to a $106,800 annual limit. The OASDI tax is usually referred to as FICA (the Federal Insurance Contribution Act).

In 1965, Congress passed the first federal health insurance program for the aged—popularly known as Medicare. This two-part program alleviates the high cost of

6Corporate taxes are based on a progressive tax rate structure. Companies with taxable income of $50,000 or less are taxed at a 15 percent rate; higher levels of income are taxed at rates ranging up to 39 percent.
medical care for those over age 65. A separate Hospital Insurance tax, paid by both the employee and the employer at the rate of 1.45 percent on the employee’s total compensation, finances the Basic Plan, which provides hospital and other institutional services. The Voluntary Plan covers the major part of doctors’ bills and other medical and health services. Monthly payments from all who enroll, plus matching funds from the federal government, finance this plan.

The combination of the OASDI tax (FICA) and the federal Hospital Insurance Tax is commonly referred to as the Social Security tax. The combined rate for these taxes, 7.65 percent on an employee’s wages to $106,800 and 1.45 percent in excess of $106,800, changes intermittently by acts of Congress. Companies should report the amount of unremitting employee and employer Social Security tax on gross wages paid as a current liability.

Unemployment Taxes. Another payroll tax levied by the federal government in cooperation with state governments provides a system of unemployment insurance. All employers who meet the following criteria are subject to the Federal Unemployment Tax Act (FUTA): (1) those who paid wages of $1,500 or more during any calendar quarter in the year or preceding year, or (2) those who employed at least one individual on at least one day in each of 20 weeks during the current or preceding calendar year.

Only employers pay the unemployment tax. The rate of this tax is 6.2 percent on the first $7,000 of compensation paid to each employee during the calendar year. The employer receives a tax credit not to exceed 5.4 percent for contributions paid to a state plan for unemployment compensation. Thus, if an employer is subject to a state unemployment tax of 5.4 percent or more, it pays only 0.8 percent tax to the federal government.

State unemployment compensation laws differ both from the federal law and among various states. Therefore, employers must refer to the unemployment tax laws in each state in which they pay wages and salaries. The normal state tax may range from 3 percent to 7 percent or higher. However, all states provide for some form of merit rating, which reduces the state contribution rate. Employers who display by their benefit and contribution experience that they provide steady employment may receive this reduction—if the size of the state fund is adequate. In order not to penalize an employer who has earned a reduction in the state contribution rate, federal law allows a credit of 5.4 percent, even when the effective state contribution rate is less than 5.4 percent.

To illustrate, Appliance Repair Co. has a taxable payroll of $100,000. It is subject to a federal rate of 6.2 percent and a state contribution rate of 5.7 percent. However, its stable employment experience reduces the company’s state rate to 1 percent. Appliance Repair computes its federal and state unemployment taxes as shown in Illustration 13-4.

| State unemployment tax payment (1% × $100,000) | $1,000 |
| Federal unemployment tax [(6.2% − 5.4%) × $100,000] | 800 |
| **Total federal and state unemployment tax** | **$1,800** |

Companies pay federal unemployment tax quarterly, and file a tax form annually. Companies also generally pay state contributions quarterly as well. Because both the federal and the state unemployment taxes accrue on earned compensation, companies should record the amount of accrued but unpaid employer contributions as an operating expense and as a current liability when preparing financial statements at year-end.

Income Tax Withholding. Federal and some state income tax laws require employers to withhold from each employee’s pay the applicable income tax due on those wages. The
Chapter 13 Current Liabilities and Contingencies

employer computes the amount of income tax to withhold according to a government-prescribed formula or withholding tax table. That amount depends on the length of the pay period and each employee’s taxable wages, marital status, and claimed dependents. If the income tax withheld plus the employee and the employer Social Security taxes exceeds specified amounts per month, the employer must make remittances to the government during the month. Illustration 13-5 summarizes payroll deductions and liabilities.

ILLUSTRATION 13-5
Summary of Payroll Liabilities

<table>
<thead>
<tr>
<th>Item</th>
<th>Who Pays</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income tax withholding</td>
<td>Employee</td>
</tr>
<tr>
<td>FICA taxes—employee share</td>
<td>Employer</td>
</tr>
<tr>
<td>Union dues</td>
<td>Employer</td>
</tr>
<tr>
<td>FICA taxes—employer share</td>
<td></td>
</tr>
<tr>
<td>Federal unemployment</td>
<td></td>
</tr>
<tr>
<td>State unemployment</td>
<td></td>
</tr>
</tbody>
</table>

Payroll Deductions Example. Assume a weekly payroll of $10,000 entirely subject to FICA and Medicare (7.65%), federal (0.8%) and state (4%) unemployment taxes, with income tax withholding of $1,320 and union dues of $88 deducted. The company records the salaries and wages paid and the employee payroll deductions as follows.

Salaries and Wages Expense 10,000
Withholding Taxes Payable 1,320
FICA Taxes Payable 765
Union Dues Payable 88
Cash 7,827

It records the employer payroll taxes as follows.

Payroll Tax Expense 1,245
FICA Taxes Payable 765
FUTA Taxes Payable 80
SUTA Taxes Payable 400

The employer must remit to the government its share of FICA tax along with the amount of FICA tax deducted from each employee’s gross compensation. It should record all unremitting employer FICA taxes as payroll tax expense and payroll tax payable.\(^7\)

Compensated Absences

Compensated absences are paid absences from employment—such as vacation, illness, and holidays. Companies should accrue a liability for the cost of compensation for future absences if all of the following conditions exist. [6]

(a) The employer’s obligation relating to employees’ rights to receive compensation for future absences is attributable to employees’ services already rendered.
(b) The obligation relates to the rights that vest or accumulate.
(c) Payment of the compensation is probable.
(d) The amount can be reasonably estimated. [7]\(^8\)

\(^7\)A manufacturing company allocates all of the payroll costs (wages, payroll taxes, and fringe benefits) to appropriate cost accounts such as Direct Labor, Indirect Labor, Sales Salaries, Administrative Salaries, and the like. This abbreviated and somewhat simplified discussion of payroll costs and deductions is not indicative of the volume of records and clerical work that may be involved in maintaining a sound and accurate payroll system.

\(^8\)Companies provide postemployment benefits to past or inactive employees after employment but prior to retirement. Examples include salary continuation, supplemental unemployment benefits, severance pay, job training, and continuation of health and life insurance coverage.
The following considerations are relevant to the accounting for compensated absences.

**Vested rights** exist when an employer has an obligation to make payment to an employee even after terminating his or her employment. Thus, vested rights are not contingent on an employee’s future service.

**Accumulated rights** are those that employees can carry forward to future periods if not used in the period in which earned. For example, assume that you earn four days of vacation pay as of December 31, the end of your employer’s fiscal year. Company policy is that you will be paid for this vacation time even if you terminate employment. In this situation, your four days of vacation pay are vested, and your employer must accrue the amount.

Now assume that your vacation days are not vested, but that you can carry the four days over into later periods. Although the rights are not vested, they are accumulated rights for which the employer must make an accrual. However, the amount of the accrual is adjusted to allow for estimated forfeitures due to turnover.

A modification of the general rules relates to the issue of **sick pay**. If sick pay benefits vest, a company must accrue them. If sick pay benefits accumulate but do not vest, a company may choose whether to accrue them. Why this distinction? Companies may administer compensation designated as sick pay in one of two ways. In some companies, employees receive sick pay only if illness causes their absence. Therefore, these companies may or may not accrue a liability because its payment depends on future employee illness. Other companies allow employees to accumulate unused sick pay and take compensated time off from work even when not ill. For this type of sick pay, a company must accrue a liability because the company will pay it, regardless of whether employees become ill.

**What Is a Current Liability? 733**

Illustration 13-6 shows an example of an accrual for compensated absences, in an excerpt from the balance sheet of Clarcor Inc.

### Clarcor Inc.

<table>
<thead>
<tr>
<th>Current liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
</tr>
<tr>
<td>Accrued salaries, wages and commissions</td>
</tr>
<tr>
<td>Compensated absences</td>
</tr>
<tr>
<td>Accrued pension liabilities</td>
</tr>
<tr>
<td>Other accrued liabilities</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>

If an employer meets conditions (a), (b), and (c) but does not accrue a liability because of a failure to meet condition (d), it should disclose that fact. Illustration 13-7 shows an example of such a disclosure, in a note from the financial statements of Gotham Utility Company.

### Gotham Utility Company

Employees of the Company are entitled to paid vacation, personal, and sick days off, depending on job status, length of service, and other factors. Due to numerous differing union contracts and other agreements with nonunion employees, it is impractical to estimate the amount of compensation for future absences, and, accordingly, no liability has been reported in the accompanying financial statements. The Company’s policy is to recognize the cost of compensated absences when actually paid to employees; compensated absence payments to employees totaled $2,786,000.

The following considerations are relevant to the accounting for compensated absences.

**Vested rights** exist when an employer has an obligation to make payment to an employee even after terminating his or her employment. Thus, vested rights are not contingent on an employee’s future service. **Accumulated rights** are those that employees can carry forward to future periods if not used in the period in which earned. For example, assume that you earn four days of vacation pay as of December 31, the end of your employer’s fiscal year. Company policy is that you will be paid for this vacation time even if you terminate employment. In this situation, your four days of vacation pay are vested, and your employer must accrue the amount.

Now assume that your vacation days are not vested, but that you can carry the four days over into later periods. Although the rights are not vested, they are accumulated rights for which the employer must make an accrual. However, the amount of the accrual is adjusted to allow for estimated forfeitures due to turnover.

A modification of the general rules relates to the issue of **sick pay**. If sick pay benefits vest, a company must accrue them. If sick pay benefits accumulate but do not vest, a company may choose whether to accrue them. Why this distinction? Companies may administer compensation designated as sick pay in one of two ways. In some companies, employees receive sick pay only if illness causes their absence. Therefore, these companies may or may not accrue a liability because its payment depends on future employee illness. Other companies allow employees to accumulate unused sick pay and take compensated time off from work even when not ill. For this type of sick pay, a company must accrue a liability because the company will pay it, regardless of whether employees become ill.
Chapter 13 Current Liabilities and Contingencies

Companies should recognize the expense and related liability for compensated absences in the year earned by employees. For example, if new employees receive rights to two weeks’ paid vacation at the beginning of their second year of employment, a company considers the vacation pay to be earned during the first year of employment.

What rate should a company use to accrue the compensated absence cost—the current rate or an estimated future rate? GAAP is silent on this subject. Therefore, companies will likely use the current rather than future rate. The future rate is less certain and raises time value of money issues. To illustrate, assume that Amutron Inc. began operations on January 1, 2012. The company employs 10 individuals and pays each $480 per week. Employees earned 20 unused vacation weeks in 2012. In 2013, the employees used the vacation weeks, but now they each earn $540 per week. Amutron accrues the accumulated vacation pay on December 31, 2012, as follows.

| Salaries and Wages Expense | 9,600 |
| Salaries and Wages Payable (\$480 \times 20) | 9,600 |

At December 31, 2012, the company reports on its balance sheet a liability of $9,600. In 2013, it records the payment of vacation pay as follows.

| Salaries and Wages Payable | 9,600 |
| Salaries and Wages Expense | 1,200 |
| Cash (\$540 \times 20) | 10,800 |

In 2013, the use of the vacation weeks extinguishes the liability. Note that Amutron records the difference between the amount of cash paid and the reduction in the liability account as an adjustment to Salaries and Wages Expense in the period when paid. This difference arises because it accrues the liability account at the rates of pay in effect during the period when employees earned the compensated time. The cash paid, however, depends on the rates in effect during the period when employees used the compensated time. If Amutron used the future rates of pay to compute the accrual in 2012, then the cash paid in 2013 would equal the liability.9

**Bonus Agreements**

Many companies give a *bonus* to certain or all employees in addition to their regular salaries or wages. Frequently the bonus amount depends on the company’s yearly profit. For example, employees at *Ford Motor Company* share in the success of the company’s operations on the basis of a complicated formula using net income as its primary basis for computation. A company may consider *bonus payments to employees* as additional wages and should include them as a deduction in determining the net income for the year.

To illustrate the entries for an employee bonus, assume that Palmer Inc. shows income for the year 2012 of $100,000. It will pay out bonuses of $10,700 in January 2013. Palmer makes an adjusting entry dated December 31, 2012, to record the bonuses as follows.

| Salaries and Wages Expense | 10,700 |
| Salaries and Wages Payable | 10,700 |

In January 2013, when Palmer pays the bonus, it makes this journal entry:

| Salaries and Wages Payable | 10,700 |
| Cash | 10,700 |

Palmer should show the expense account in the income statement as an operating expense. The liability, Salaries and Wages Payable, is usually payable within a short

---

9Some companies have obligations for benefits paid to employees after they retire. The accounting and reporting standards for postretirement benefit payments are complex. These standards relate to two different types of *postretirement benefits*: (1) pensions, and (2) postretirement health care and life insurance benefits. We discuss these issues extensively in Chapter 20.
Companies often are involved in situations where uncertainty exists about whether an obligation to transfer cash or other assets has arisen and/or the amount that will be required to settle the obligation. For example:

- **Merck** may be a defendant in a lawsuit, and any payment is contingent upon the outcome of a settlement or an administrative or court proceeding.
- **Ford Motor Co.** provides a warranty for a car it sells, and any payments are contingent on the number of cars that qualify for benefits under the warranty.
- **Briggs & Stratton** acts as a guarantor on a loan for another entity, and any payment is contingent on whether the other entity defaults.

Broadly, these situations are called contingencies. A **contingency** is “an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (gain contingency) or loss (loss contingency) to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur.” [8]

### GAIN CONTINGENCIES

**Gain contingencies** are claims or rights to receive assets (or have a liability reduced) whose existence is uncertain but which may become valid eventually. The typical gain contingencies are:

1. Possible receipts of monies from gifts, donations, asset sales, and so on.
2. Possible refunds from the government in tax disputes.
3. Pending court cases with a probable favorable outcome.
4. Tax loss carryforwards (discussed in Chapter 19).

Companies follow a conservative policy in this area. Except for tax loss carryforwards, they do not record gain contingencies. A company discloses gain contingencies in the notes only when a high probability exists for realizing them. As a result, it

---

10 According to *Accounting Trends and Techniques—2010*, the most common gain contingencies are related to operating loss carryforwards and other tax credits and to tax credit carryforwards.
Chapter 13 Current Liabilities and Contingencies

is unusual to find information about contingent gains in the financial statements and the accompanying notes. Illustration 13-8 presents an example of a gain contingency disclosure.

ILLUSTRATION 13-8
Disclosure of Gain Contingency

Illustration 13-8
Disclosure of Gain Contingency

BMC Industries, Inc.

Note 13: Legal Matters. In the first quarter, a U.S. District Court in Miami, Florida, awarded the Company a $5.1 million judgment against Barth Industries (Barth) of Cleveland, Ohio and its parent, Nesco Holdings, Inc. (Nesco). The judgment relates to an agreement under which Barth and Nesco were to help automate the plastic lens production plant in Fort Lauderdale, Florida. The Company has not recorded any income relating to this judgment because Barth and Nesco have filed an appeal.

LOSS CONTINGENCIES

Loss contingencies involve possible losses. A liability incurred as a result of a loss contingency is by definition a contingent liability. Contingent liabilities depend on the occurrence of one or more future events to confirm either the amount payable, the payee, the date payable, or its existence. That is, these factors depend on a contingency.

Likelihood of Loss

When a loss contingency exists, the likelihood that the future event or events will confirm the incurrence of a liability can range from probable to remote. The FASB uses the terms probable, reasonably possible, and remote to identify three areas within that range and assigns the following meanings.

Probable. The future event or events are likely to occur.

Reasonably possible. The chance of the future event or events occurring is more than remote but less than likely.

Remote. The chance of the future event or events occurring is slight.

Companies should accrue an estimated loss from a loss contingency by a charge to expense and a liability recorded only if both of the following conditions are met.

1. Information available prior to the issuance of the financial statements indicates that it is probable that a liability has been incurred at the date of the financial statements.

2. The amount of the loss can be reasonably estimated.

To record a liability, a company does not need to know the exact payee nor the exact date payable. What a company must know is whether it is probable that it incurred a liability.

To meet the second criterion, a company needs to be able to reasonably determine an amount for the liability. To determine a reasonable estimate of the liability, a company may use its own experience, experience of other companies in the industry, engineering or research studies, legal advice, or educated guesses by qualified personnel.

We discuss loss contingencies that result in the incurrence of a liability in this chapter. We discuss loss contingencies that result in the impairment of an asset (e.g., collectibility of receivables or threat of expropriation of assets) in other sections of this textbook.
Practicing accountants express concern over the diversity that now exists in the interpretation of “probable,” “reasonably possible,” and “remote.” Current practice relies heavily on the exact language used in responses received from lawyers (such language is necessarily biased and protective rather than predictive). As a result, accruals and disclosures of contingencies vary considerably in practice. Some of the more common loss contingencies are:

1. Litigation, claims, and assessments.
2. Guarantee and warranty costs.
3. Premiums and coupons.
4. Environmental liabilities.

12Accounting Trends and Techniques—2010 discloses that 500 companies report loss contingencies for the following: litigation, 379; environmental, 203; possible tax assessments, 145; insurance, 132; governmental investigation, 95; and others, 63.
Chapter 13 Current Liabilities and Contingencies

As discussed in the opening story, companies do not record or report in the notes to the financial statements general risk contingencies inherent in business operations (e.g., the possibility of war, strike, uninsured catastrophes, or a business recession).

Litigation, Claims, and Assessments

Companies must consider the following factors, among others, in determining whether to record a liability with respect to pending or threatened litigation and actual or possible claims and assessments.

1. The time period in which the underlying cause of action occurred.
2. The probability of an unfavorable outcome.
3. The ability to make a reasonable estimate of the amount of loss.

To report a loss and a liability in the financial statements, the cause for litigation must have occurred on or before the date of the financial statements. It does not matter that the company became aware of the existence or possibility of the lawsuit or claims after the date of the financial statements but before issuing them. To evaluate the probability of an unfavorable outcome, a company considers the following: the nature of the litigation; the progress of the case; the opinion of legal counsel; its own and others’ experience in similar cases; and any management response to the lawsuit.

Companies can seldom predict the outcome of pending litigation, however, with any assurance. And, even if evidence available at the balance sheet date does not favor the company, it is hardly reasonable to expect the company to publish in its financial statements a dollar estimate of the probable negative outcome. Such specific disclosures might weaken the company’s position in the dispute and encourage the plaintiff to intensify its efforts. A typical example of the wording of such a disclosure is the note to the financial statements of Apple Computer, Inc., relating to its litigation concerning repetitive stress injuries, as shown in Illustration 13-11.

Illustration 13-11
Disclosure of Litigation

Apple Computer, Inc.

“Repetitive Stress Injury” Litigation. The Company is named in numerous lawsuits (fewer than 100) alleging that the plaintiff incurred so-called “repetitive stress injury” to the upper extremities as a result of using keyboards and/or mouse input devices sold by the Company. On October 4, in a trial of one of these cases (Dorsey v. Apple) in the United States District Court for the Eastern District of New York, the jury rendered a verdict in favor of the Company, and final judgment in favor of the Company has been entered. The other cases are in various stages of pretrial activity. These suits are similar to those filed against other major suppliers of personal computers. Ultimate resolution of the litigation against the Company may depend on progress in resolving this type of litigation in the industry overall.

With respect to unfiled suits and unasserted claims and assessments, a company must determine (1) the degree of probability that a suit may be filed or a claim or assessment may be asserted, and (2) the probability of an unfavorable outcome. For example, assume that the Federal Trade Commission investigates the Nawtee Company for restraint of trade, and institutes enforcement proceedings. Private claims of triple damages for redress often follow such proceedings. In this case, Nawtee must determine the probability of the claims being asserted and the probability of triple damages being awarded. If both are probable, if the loss is reasonably estimable, and if the cause for
action is dated on or before the date of the financial statements, then Nawtee should accrue the liability.\footnote{Companies need not disclose contingencies involving an unasserted claim or assessment when no claimant has come forward unless (1) it is considered probable that a claim will be asserted, and (2) there is a reasonable possibility that the outcome will be unfavorable. The FASB has started a project to require disclosures that are sufficient to enable users of financial statements to assess the likelihood, timing, and amount of future cash flows associated with loss contingencies. As indicated in the opening story, this project and its proposed recommendations are extremely controversial. See \url{http://www.fasb.org/project/accounting_for_contingencies.shtml}.}

**Guarantee and Warranty Costs**

A **warranty** (product guarantee) is a promise made by a seller to a buyer to make good on a deficiency of quantity, quality, or performance in a product. Manufacturers commonly use it as a sales promotion technique. Automakers, for instance, “hyped” their sales by extending their new-car warranty to seven years or 100,000 miles. For a specified period of time following the date of sale to the consumer, the manufacturer may promise to bear all or part of the cost of replacing defective parts, to perform any necessary repairs or servicing without charge, to refund the purchase price, or even to “double your money back.”

Warranties and guarantees entail future costs. These additional costs, sometimes called “after costs” or “post-sale costs,” frequently are significant. Although the future cost is indefinite as to amount, due date, and even customer, a liability is probable in most cases. Companies should recognize this liability in the accounts if they can reasonably estimate it. The estimated amount of the liability includes all the costs that the company will incur after sale and delivery and that are incident to the correction of defects or deficiencies required under the warranty provisions. Warranty costs are a classic example of a loss contingency.

Companies use two basic methods of accounting for warranty costs: (1) the cash-basis method and (2) the accrual method.

**Cash Basis**

Under the **cash-basis method**, companies expense warranty costs as incurred. In other words, a seller or manufacturer charges warranty costs to the period in which it complies with the warranty. The company does not record a liability for future costs arising from warranties, nor does it charge the period of sale. Companies frequently justify use of this method, the only one recognized for income tax purposes, on the basis of expediency when warranty costs are immaterial or when the warranty period is relatively short. A company must use the cash-basis method when it does not accrue a warranty liability in the year of sale either because:

1. it is not probable that a liability has been incurred, or
2. it cannot reasonably estimate the amount of the liability.

**Accrual Basis**

If it is probable that customers will make warranty claims and a company can reasonably estimate the costs involved, the company must use the accrual method. Under the **accrual method**, companies charge warranty costs to operating expense in the year of sale. The accrual method is the generally accepted method. Companies should use it whenever the warranty is an integral and inseparable part of the sale and is viewed as a loss contingency. We refer to this approach as the **expense warranty approach**.

**Example of Expense Warranty Approach.** To illustrate the expense warranty method, assume that Denson Machinery Company begins production on a new machine in July.
Chapter 13 Current Liabilities and Contingencies

2012, and sells 100 units at $5,000 each by its year-end, December 31, 2012. Each machine is under warranty for one year. Denson estimates, based on past experience with a similar machine, that the warranty cost will average $200 per unit. Further, as a result of parts replacements and services rendered in compliance with machinery warranties, it incurs $4,000 in warranty costs in 2012 and $16,000 in 2013.

1. Sale of 100 machines at $5,000 each, July through December 2012:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash or Accounts Receivable</td>
<td>500,000</td>
</tr>
<tr>
<td>Sales Revenue</td>
<td>500,000</td>
</tr>
</tbody>
</table>

2. Recognition of warranty expense, July through December 2012:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Warranty Expense</td>
<td>4,000</td>
</tr>
<tr>
<td>Cash, Inventory, Accrued Payroll</td>
<td>4,000</td>
</tr>
<tr>
<td>(Warranty costs incurred)</td>
<td></td>
</tr>
<tr>
<td>Warranty Expense</td>
<td>16,000</td>
</tr>
<tr>
<td>Warranty Liability</td>
<td>16,000</td>
</tr>
<tr>
<td>(To accrue estimated warranty costs)</td>
<td></td>
</tr>
</tbody>
</table>

The December 31, 2012, balance sheet reports “Warranty liability” as a current liability of $16,000, and the income statement for 2012 reports “Warranty expense” of $20,000.

3. Recognition of warranty costs incurred in 2013 (on 2012 machinery sales):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Warranty Liability</td>
<td>16,000</td>
</tr>
<tr>
<td>Cash, Inventory, Accrued Payroll</td>
<td>16,000</td>
</tr>
<tr>
<td>(Warranty costs incurred)</td>
<td></td>
</tr>
</tbody>
</table>

If Denson Machinery applies the cash-basis method, it reports $4,000 as warranty expense in 2012 and $16,000 as warranty expense in 2013. It records all of the sale price as revenue in 2012. In many instances, application of the cash-basis method fails to record the warranty costs relating to the products sold during a given period with the revenues derived from such products. As such, it violates the expense recognition principle. Where ongoing warranty policies exist year after year, the differences between the cash and the expense warranty bases probably would not be so great.

Sales Warranty Approach. A warranty is sometimes sold separately from the product. For example, when you purchase a television set or DVD player, you are entitled to the manufacturer’s warranty. You also will undoubtedly be offered an extended warranty on the product at an additional cost. In this case, the seller should recognize separately the sale of the television or DVD player, with the manufacturer’s warranty and the sale of the extended warranty. Companies defer revenue on the sale of the extended warranty and generally recognize it on a straight-line basis over the life of the contract. The seller of the warranty defers revenue because it has an obligation to perform services over the life of the contract. The seller should only defer and amortize costs that vary with and are directly related to the sale of the contracts (mainly commissions). It expenses those costs, such as employees’ salaries, advertising, and general and administrative expenses, that it would have incurred even if it did not sell a contract.

To illustrate, assume you purchase a new automobile from Hanlin Auto for $20,000. In addition to the regular warranty on the auto (the manufacturer will pay for all repairs...
for the first 36,000 miles or three years, whichever comes first), you purchase at a cost of $600 an extended warranty that protects you for an additional three years or 36,000 miles. Hanlin Auto records the sale of the automobile (with the regular warranty) and the sale of the extended warranty on January 2, 2012, as follows.

<table>
<thead>
<tr>
<th>Cash</th>
<th>20,600</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Revenue</td>
<td>20,000</td>
</tr>
<tr>
<td>Unearned Warranty Revenue</td>
<td>600</td>
</tr>
</tbody>
</table>

It recognizes revenue at the end of the fourth year (using straight-line amortization) as follows.

<table>
<thead>
<tr>
<th>Unearned Warranty Revenue</th>
<th>200</th>
</tr>
</thead>
<tbody>
<tr>
<td>Warranty Revenue</td>
<td>200</td>
</tr>
</tbody>
</table>

Because the extended warranty contract only starts after the regular warranty expires, Hanlin Auto defers revenue recognition until the fourth year. If it incurs the costs of performing services under the extended warranty contract on other than a straight-line basis (as historical evidence might indicate), Hanlin Auto should recognize revenue over the contract period in proportion to the costs it expected to incur in performing services under the contract. [10]

**Premiers and Coupons**

Numerous companies offer premiums (either on a limited or continuing basis) to customers in return for boxtops, certificates, coupons, labels, or wrappers. The **premium** may be silverware, dishes, a small appliance, a toy, or free transportation. Also, **printed coupons** that can be redeemed for a cash discount on items purchased are extremely popular. A more recent marketing innovation is the **cash rebate**, which the buyer can obtain by returning the store receipt, a rebate coupon, and Universal Product Code (UPC label) or “bar code” to the manufacturer. [16]

Companies offer premiums, coupon offers, and rebates to stimulate sales. Thus companies should charge the costs of premiums and coupons to expense in the **period of the sale** that benefits from the plan. The period that benefits is not necessarily the period in which the company offered the premium. At the end of the accounting period many premium offers may be outstanding and must be redeemed when presented in subsequent periods. In order to reflect the existing current liability and to match costs with revenues, the company estimates the number of outstanding premium offers that customers will present for redemption. The company then charges the cost of premium offers to Premium Expense. It credits the outstanding obligations to an account titled Premium Liability.

The following example illustrates the accounting treatment for a premium offer. Fluffy Cakemix Company offered its customers a large nonbreakable mixing bowl in exchange for 25 cents and 10 boxtops. The mixing bowl costs Fluffy Cakemix Company 75 cents, and the company estimates that customers will redeem 60 percent of the boxtops. The premium offer began in June 2012 and resulted in the transactions journalized

15The FASB requires additional disclosure requirements for warranties. A company must disclose its accounting policy and the method used to determine its warranty liability, and must present a tabular reconciliation of the changes in the product warranty liability. [11]

16Nearly 40 percent of cash rebates never get redeemed, and some customers complain about how difficult the rebate process is. See B. Grow, “The Great Rebate Runaround,” *BusinessWeek* (December 5, 2005), pp. 34–37. Approximately 4 percent of coupons are redeemed. Redeemed coupons eventually make their way to clearinghouses operated by **A. C. Nielsen Company** (of TV-rating fame) that count them and report back to the manufacturers who, in turn, reimburse the stores.
Fluffy Cakemix Company records purchase of 20,000 mixing bowls at 75 cents as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory of Premiums</td>
<td>15,000</td>
</tr>
<tr>
<td>Cash</td>
<td>15,000</td>
</tr>
</tbody>
</table>

The entry to record sales of 300,000 boxes of cake mix at 80 cents would be:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>240,000</td>
</tr>
<tr>
<td>Sales Revenue</td>
<td>240,000</td>
</tr>
</tbody>
</table>

Fluffy records the actual redemption of 60,000 boxtops, the receipt of 25 cents per 10 boxtops, and the delivery of the mixing bowls as follows.

\[
\text{Cash } ([60,000 \div 10] \times \$0.25) = 1,500  \\
\text{Premium Expense} = 3,000  \\
\text{Inventory of Premiums} = 4,500  \\
\text{Computation: } (60,000 \div 10) \times \$0.75 = \$4,500
\]

Finally, Fluffy makes an end-of-period adjusting entry for estimated liability for outstanding premium offers (boxtops) as follows.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium Expense</td>
<td>6,000</td>
</tr>
<tr>
<td>Premium Liability</td>
<td>6,000</td>
</tr>
</tbody>
</table>

\[
\text{Computation: } \\
\begin{align*}
\text{Total boxtops sold in 2012} & = 300,000  \\
\text{Total estimated redemptions (60%)} & = 180,000  \\
\text{Boxtops redeemed in 2012} & = 60,000  \\
\text{Estimated future redemptions} & = 120,000  \\
\text{Cost of estimated claims outstanding} & = (120,000 \div 10) \times \$0.75 \div \$0.25 = \$6,000
\end{align*}
\]

The December 31, 2012, balance sheet of Fluffy Cakemix Company reports an “Inventory of premiums” of $10,500 for the premium mixing bowls as a current asset and “Premium liability” of $6,000 as a current liability. The 2012 income statement reports a $9,000 “Premium expense” among the selling expenses.

**FREQUENT FLYERS**

Numerous companies offer premiums to customers in the form of a promise of future goods or services as an incentive for purchases today. Premium plans that have widespread adoption are the frequent-flyer programs used by all major airlines. On the basis of mileage accumulated, frequent-flyer members receive discounted or free airline tickets. Airline customers can earn miles toward free travel by making long-distance phone calls, staying in hotels, and charging gasoline and groceries on a credit card. Those free tickets represent an enormous potential liability because people using them may displace paying passengers.

When airlines first started offering frequent-flyer bonuses, everyone assumed that they could accommodate the free-ticket holders with otherwise-empty seats. That made the additional cost of the program so minimal that airlines didn’t accrue it or report the small liability. But, as more and more paying passengers have been crowded off flights by frequent-flyer awardees, the loss of revenues has grown enormously. For example, United Airlines at one time reported a liability of $1.5 billion for advance ticket sales, some of which pertains to free frequent-flyer tickets.

Although the profession has studied the accounting for this transaction, no authoritative guidelines have been issued.

**Environmental Liabilities**

Estimates to clean up existing toxic waste sites total upward of $752 billion over a 30-year period. In addition, cost estimates of cleaning up our air and preventing future
deterioration of the environment run even higher. These costs are likely to only grow, considering “Superfund legislation.” This federal legislation provides the Environmental Protection Agency (EPA) with the power to clean up waste sites and charge the clean-up costs to parties the EPA deems responsible for contaminating the site. These potentially responsible parties can have a significant liability.

In many industries, the construction and operation of long-lived assets involves obligations for the retirement of those assets. When a mining company opens up a strip mine, it may also commit to restore the land once it completes mining. Similarly, when an oil company erects an offshore drilling platform, it may be legally obligated to dismantle and remove the platform at the end of its useful life.

**Accounting Recognition of Asset Retirement Obligations**

A company must recognize an asset retirement obligation (ARO) when it has an existing legal obligation associated with the retirement of a long-lived asset and when it can reasonably estimate the amount of the liability. Companies should record the ARO at fair value. [12]

**Obligating Events.** Examples of existing legal obligations, which require recognition of a liability include, but are not limited to:

- Decommissioning nuclear facilities;
- Dismantling, restoring, and reclamation of oil and gas properties;
- Certain closure, reclamation, and removal costs of mining facilities; and
- Closure and post-closure costs of landfills.

In order to capture the benefits of these long-lived assets, the company is generally legally obligated for the costs associated with retirement of the asset, whether the company hires another party to perform the retirement activities or performs the activities with its own workforce and equipment. AROs give rise to various recognition patterns. For example, the obligation may arise at the outset of the asset’s use (e.g., erection of an oil-rig), or it may build over time (e.g., a landfill that expands over time).

**Measurement.** A company initially measures an ARO at fair value, which is defined as the amount that the company would pay in an active market to settle the ARO. While active markets do not exist for many AROs, companies should estimate fair value based on the best information available. Such information could include market prices of similar liabilities, if available. Alternatively, companies may use present value techniques to estimate fair value.

**Recognition and Allocation.** To record an ARO in the financial statements, a company includes the cost associated with the ARO in the carrying amount of the related long-lived asset, and records a liability for the same amount. It records an asset retirement cost as part of the related asset because these costs are tied to operating the asset and are necessary to prepare the asset for its intended use. Therefore, the specific asset (e.g., mine, drilling platform, nuclear power plant) should be increased because the future economic benefit comes from the use of this productive asset. **Companies should not record the capitalized asset retirement costs in a separate account because there is no future economic benefit that can be associated with these costs alone.**

In subsequent periods, companies allocate the cost of the ARO to expense over the period of the related asset’s useful life. Companies may use the straight-line method for this allocation, as well as other systematic and rational allocations.
Chapter 13 Current Liabilities and Contingencies

Example of ARO Accounting Provisions. To illustrate the accounting for AROs, assume that on January 1, 2012, Wildcat Oil Company erected an oil platform in the Gulf of Mexico. Wildcat is legally required to dismantle and remove the platform at the end of its useful life, estimated to be five years. Wildcat estimates that dismantling and removal will cost $1,000,000. Based on a 10 percent discount rate, the fair value of the asset retirement obligation is estimated to be $620,920 ($1,000,000 \times .62092). Wildcat records this ARO as follows.

January 1, 2012

\[
\begin{align*}
\text{Drilling Platform} & \quad 620,920 \\
\text{Asset Retirement Obligation} & \quad 620,920
\end{align*}
\]

During the life of the asset, Wildcat allocates the asset retirement cost to expense. Using the straight-line method, Wildcat makes the following entries to record this expense.


\[
\begin{align*}
\text{Depreciation Expense ($620,920 ÷ 5)} & \quad 124,184 \\
\text{Accumulated Depreciation} & \quad 124,184
\end{align*}
\]

In addition, Wildcat must accrue interest expense each period. Wildcat records interest expense and the related increase in the asset retirement obligation on December 31, 2012, as follows.

December 31, 2012

\[
\begin{align*}
\text{Interest Expense ($620,920 × 10%)} & \quad 62,092 \\
\text{Asset Retirement Obligation} & \quad 62,092
\end{align*}
\]

On January 10, 2017, Wildcat contracts with Rig Reclaimers, Inc. to dismantle the platform at a contract price of $995,000. Wildcat makes the following journal entry to record settlement of the ARO.

January 10, 2017

\[
\begin{align*}
\text{Asset Retirement Obligation} & \quad 1,000,000 \\
\text{Gain on Settlement of ARO} & \quad 5,000 \\
\text{Cash} & \quad 995,000
\end{align*}
\]

Companies provide extensive disclosure regarding environmental liabilities. In addition, some believe that companies should record more of these liabilities. The SEC recommends that companies not delay recognition of a liability due to significant uncertainty. The SEC argues that if the liability is within a range, and no amount within the range is the best estimate, then management should recognize the minimum amount of the range. That treatment is in accordance with GAAP. The SEC also believes that companies should report environmental liabilities in the balance sheet independent of recoveries from third parties. Thus, companies may not net possible insurance recoveries against liabilities but must show them separately. Because there is much litigation regarding recovery of insurance proceeds, these “assets” appear to be gain contingencies. Therefore, companies should not report these on the balance sheet.\(^{17}\)

\(^{17}\) As we indicated earlier, the FASB requires that, when some amount within the range appears at the time to be a better estimate than any other amount within the range, a company accrues that amount. When no amount within the range is a better estimate than any other amount, the company accrues the dollar amount at the low end of the range and discloses the dollar amount at the high end of the range. Unfortunately, in many cases, zero may arguably be the low point of the range, resulting in no liability being recognized.\(^{13}\), \(^{14}\)
Self-Insurance

As discussed earlier, contingencies are not recorded for general risks (e.g., losses that might arise due to poor expected economic conditions). Similarly, companies do not record contingencies for more specific future risks such as allowances for repairs. The reason: These items do meet the definition of a liability because they do not arise from a past transaction but instead relate to future events.

Some companies take out insurance policies against the potential losses from fire, flood, storm, and accident. Other companies do not. The reasons: Some risks...
Chapter 13 Current Liabilities and Contingencies

are not insurable, the insurance rates are prohibitive (e.g., earthquakes and riots), or they make a business decision to self-insure. Self-insurance is another item that is not recognized as a contingency.

Despite its name, self-insurance is not insurance, but risk assumption. Any company that assumes its own risks puts itself in the position of incurring expenses or losses as they occur. There is little theoretical justification for the establishment of a liability based on a hypothetical charge to insurance expense. This is “as if” accounting. The conditions for accrual stated in GAAP are not satisfied prior to the occurrence of the event. Until that time there is no diminution in the value of the property. And unlike an insurance company, which has contractual obligations to reimburse policyholders for losses, a company can have no such obligation to itself and, hence, no liability either before or after the occurrence of damage. [15]

The note shown in Illustration 13-12 from the annual report of Molson Coors Brewing Company is typical of the self-insurance disclosure.

Exposure to risks of loss resulting from uninsured past injury to others, however, is an existing condition involving uncertainty about the amount and timing of losses that may develop. In such a case, a contingency exists. A company with a fleet of vehicles for example, would have to accrue uninsured losses resulting from injury to others or damage to the property of others that took place prior to the date of the financial statements (if the experience of the company or other information enables it to make a reasonable estimate of the liability). However, it should not establish a liability for expected future injury to others or damage to the property of others, even if it can reasonably estimate the amount of losses.

SECTION 3 • PRESENTATION AND ANALYSIS

PRESENTATION OF CURRENT LIABILITIES

In practice, current liabilities are usually recorded and reported in financial statements at their full maturity value. Because of the short time periods involved, frequently less than one year, the difference between the present value of a current liability and the maturity value is usually not large. The profession accepts as immaterial any slight overstatement of liabilities that results from carrying current liabilities at maturity value. [16]

[15] A commentary in Forbes (June 15, 1974), p. 42, stated its position on this matter quite succinctly: “The simple and unquestionable fact of life is this: Business is cyclical and full of unexpected surprises. Is it the role of accounting to disguise this unpleasant fact and create a fairyland of smoothly rising earnings? Or, should accounting reflect reality, warts and all—floods, expropriations and all manner of rude shocks?”

[16] GAAP specifically exempts from present value measurements those payables arising from transactions with suppliers in the normal course of business that do not exceed approximately one year.
The current liabilities accounts are commonly presented as the first classification in the liabilities and stockholders’ equity section of the balance sheet. Within the current liabilities section, companies may list the accounts in order of maturity, in descending order of amount, or in order of liquidation preference. Illustration 13-13 presents an excerpt of Best Buy Co.’s financial statements that is representative of the reports of large corporations.

Detail and supplemental information concerning current liabilities should be sufficient to meet the requirement of full disclosure. Companies should clearly identify secured liabilities, as well as indicate the related assets pledged as collateral. If the due date of any liability can be extended, a company should disclose the details. Companies should not offset current liabilities against assets that it will apply to their liquidation. Finally, current maturities of long-term debt are classified as current liabilities.

A major exception exists when a company will pay a currently maturing obligation from assets classified as long-term. For example, if a company will retire a bond payable using a bond sinking fund that is classified as a long-term asset, it should report the bonds payable in the long-term liabilities section. Presentation of this debt in the current liabilities section would distort the working capital position of the enterprise.

If a company excludes a short-term obligation from current liabilities because of refinancing, it should include the following in the note to the financial statements:

1. A general description of the financing agreement.
2. The terms of any new obligation incurred or to be incurred.
3. The terms of any equity security issued or to be issued.

When a company expects to refinance on a long-term basis by issuing equity securities, it is not appropriate to include the short-term obligation in stockholders’ equity. At the date of the balance sheet, the obligation is a liability and not stockholders’ equity. Illustration 13-14 (on page 748) shows the disclosure requirements for an actual refinancing situation.
Presentation of Contingencies

A company records a loss contingency and a liability if the loss is both probable and estimable. But, if the loss is either probable or estimable but not both, and if there is at least a reasonable possibility that a company may have incurred a liability, it must disclose the following in the notes.

1. The nature of the contingency.
2. An estimate of the possible loss or range of loss or a statement that an estimate cannot be made.

Illustration 13-15 presents an extensive litigation disclosure note from the financial statements of Raymark Corporation. The note indicates that Raymark charged actual losses to operations and that a further liability may exist, but that the company cannot currently estimate this liability.
Companies should disclose certain other contingent liabilities, even though the possibility of loss may be remote, as follows.

1. Guarantees of indebtedness of others.
2. Obligations of commercial banks under “stand-by letters of credit.”
3. Guarantees to repurchase receivables (or any related property) that have been sold or assigned.

Disclosure should include the nature and amount of the guarantee and, if estimable, the amount that the company can recover from outside parties.\(^{20}\) **Cities Service Company** disclosed its guarantees of others’ indebtedness in the following note.

---

**CITIES SERVICE COMPANY**

**Note 10: Contingent Liabilities.** The Company and certain subsidiaries have guaranteed debt obligations of approximately $62 million of companies in which substantial stock investments are held. Also, under long-term agreements with certain pipeline companies in which stock interests are held, the Company and its subsidiaries have agreed to provide minimum revenue for product shipments. The Company has guaranteed mortgage debt ($80 million) incurred by a 50 percent owned tanker affiliate for construction of tankers which are under long-term charter contracts to the Company and others. It is not anticipated that any loss will result from any of the above described agreements.

---

**ANALYSIS OF CURRENT LIABILITIES**

The distinction between current liabilities and long-term debt is important. It provides information about the liquidity of the company. Liquidity regarding a liability is the expected time to elapse before its payment. In other words, a liability soon to be paid is a current liability. A liquid company is better able to withstand a financial downturn. Also, it has a better chance of taking advantage of investment opportunities that develop.

Analysts use certain basic ratios such as net cash flow provided by operating activities to current liabilities, and the turnover ratios for receivables and inventory, to assess liquidity. Two other ratios used to examine liquidity are the current ratio and the acid-test ratio.

**Current Ratio**

The **current ratio** is the ratio of total current assets to total current liabilities. Illustration 13-17 shows its formula.

\[
\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}
\]

The ratio is frequently expressed as a coverage of so many times. Sometimes it is called the **working capital ratio** because working capital is the excess of current assets over current liabilities.

\(^{20}\)As discussed earlier (footnote 15), the FASB recently issued additional disclosure and recognition requirements for guarantees. The interpretation responds to confusion about the reporting of guarantees used in certain transactions. The new rules expand existing disclosure requirements for most guarantees, including loan guarantees such as standby letters of credit. It also will result in companies recognizing more liabilities at fair value for the obligations assumed under a guarantee. \(^{[17]}\)
Chapter 13 Current Liabilities and Contingencies

A satisfactory current ratio does not disclose that a portion of the current assets may be tied up in slow-moving inventories. With inventories, especially raw materials and work in process, there is a question of how long it will take to transform them into the finished product and what ultimately will be realized in the sale of the merchandise. Eliminating the inventories, along with any prepaid expenses, from the amount of current assets might provide better information for short-term creditors. Therefore, some analysts use the acid-test ratio in place of the current ratio.

Acid-Test Ratio

Many analysts favor an acid-test or quick ratio that relates total current liabilities to cash, marketable securities, and receivables. Illustration 13-18 shows the formula for this ratio. As you can see, the acid-test ratio does not include inventories.

\[
\text{Acid-test ratio} = \frac{\text{Cash} + \text{Short-term investments} + \text{Net receivables}}{\text{Current liabilities}}
\]

To illustrate the computation of these two ratios, we use the information for Best Buy Co. in Illustration 13-13 (on page 747). Illustration 13-19 shows the computation of the current and acid-test ratios for Best Buy.

\[
\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}} = \frac{\$10,566}{\$8,978} = 1.18 \text{ times}
\]

\[
\text{Acid-test ratio} = \frac{\text{Cash} + \text{Short-term investments} + \text{Net receivables}}{\text{Current liabilities}} = \frac{\$3,936}{\$8,978} = 0.44 \text{ times}
\]

From this information, it appears that Best Buy’s current position is adequate. However, the acid-test ratio is well below 1. A comparison to another retailer, RadioShack, whose current ratio is 3.08 and whose acid-test ratio is 2.06, indicates that Best Buy is carrying more inventory than its industry counterparts.

You will want to read the IFRS INSIGHTS on pages 773–781 for discussion of IFRS related to current liabilities and contingencies.
SUMMARY OF LEARNING OBJECTIVES

1. Describe the nature, type, and valuation of current liabilities. Current liabilities are obligations whose liquidation a company reasonably expects to require the use of current assets or the creation of other current liabilities. Theoretically, liabilities should be measured by the present value of the future outlay of cash required to liquidate them. In practice, companies usually record and report current liabilities at their full maturity value.

There are several types of current liabilities, such as: (1) accounts payable, (2) notes payable, (3) current maturities of long-term debt, (4) dividends payable, (5) customer advances and deposits, (6) unearned revenues, (7) taxes payable, and (8) employee-related liabilities.

2. Explain the classification issues of short-term debt expected to be refinanced. A short-term obligation is excluded from current liabilities if both of the following conditions are met: (1) the company must intend to refinance the obligation on a long-term basis, and (2) it must demonstrate an ability to consummate the refinancing.

3. Identify types of employee-related liabilities. The employee-related liabilities are: (1) payroll deductions, (2) compensated absences, and (3) bonus agreements.

4. Identify the criteria used to account for and disclose gain and loss contingencies. Gain contingencies are not recorded. Instead, they are disclosed in the notes only when the probabilities are high that a gain contingency will occur. A company should accrue an estimated loss from a loss contingency by charging expense and recording a liability only if both of the following conditions are met: (1) Information available prior to the issuance of the financial statements indicates that it is probable that a liability has been incurred at the date of the financial statements, and (2) the amount of the loss can be reasonably estimated.

5. Explain the accounting for different types of loss contingencies. The following factors must be considered in determining whether to record a liability with respect to pending or threatened litigation and actual or possible claims and assessments: (1) the time period in which the underlying cause for action occurred; (2) the probability of an unfavorable outcome; and (3) the ability to reasonably estimate the amount of loss.

If it is probable that customers will make claims under warranties relating to goods or services that have been sold and it can reasonably estimate the costs involved, the company uses the accrual method. It charges warranty costs under the accrual basis to operating expense in the year of sale.

Premiums, coupon offers, and rebates are made to stimulate sales. Companies should charge their costs to expense in the period of the sale that benefits from the premium plan.

A company must recognize asset retirement obligations when it has an existing legal obligation related to the retirement of a long-lived asset and it can reasonably estimate the amount.

6. Indicate how to present and analyze liabilities and contingencies. The current liability accounts are usually presented as the first classification in the liabilities and stockholders’ equity section of the balance sheet. Within the current liabilities section, companies may list the accounts in order of maturity, in descending order of amount, or in order of liquidation preference. Detail and supplemental information concerning current liabilities should be sufficient to meet the requirement of full disclosure. If the loss is either probable or estimable but not both, and if there is at least a reasonable possibility that a company may have incurred a liability, it should disclose in the notes both the nature of the contingency and an estimate of the possible loss. Two ratios used to analyze liquidity are the current and acid-test ratios.

KEY TERMS

accumulated rights, 733
acid-test (quick) ratio, 750
assessments, 738
asset retirement obligation, 743
bonus, 734
cash dividend payable, 727
claims, 738
compensated absences, 732
contingency, 735
contingent liabilities, 736
current liabilities, 722
current maturities of long-term debt, 725
current ratio, 749
expense warranty approach, 739
FICA, 730
FUTA, 731
gain contingencies, 735
liabilities, 722
litigation, claims, and assessments, 738
loss contingencies, 736
notes payable (trade notes payable), 723
OASDI, 730
operating cycle, 723
preferred dividends in arrears, 727
premium, 741
probable (contingency), 736
reasonably possible (contingency), 736
remote (contingency), 736
returnable cash deposits, 727
sales warranty approach, 740
self-insurance, 746
short-term obligations expected to be refinanced, 725
Social Security tax, 731
trade accounts payable, 723
trade notes payable, 723
unearned revenues, 728
vested rights, 733
warranty, 739
working capital ratio, 749
FASB Codification References


**Questions 753**

**Exercises**

If your school has a subscription to the FASB Codification, go to [http://aaahq.org/asclogin.cfm](http://aaahq.org/asclogin.cfm) to log in and prepare responses to the following. Provide Codification references for your responses.

**CE13-1** Access the glossary ("Master Glossary") to answer the following.

(a) What is an asset retirement obligation?
(b) What is the definition of "current liabilities"?
(c) What does it mean if something is "reasonably possible"?
(d) What is a warranty?

**CE13-2** What must an entity disclose about its asset retirement obligations?

**CE13-3** What are three examples of estimates that are used in accounting that are not contingencies? Can you explain why they are not considered contingencies?

**CE13-4** Under what conditions must an employer accrue a liability for employees’ compensation for future absences?

An additional Codification case can be found in the Using Your Judgment section, on page 772.

---

**QUESTIONS**

1. Distinguish between a current liability and a long-term debt.
2. Assume that your friend Will Morris, who is a music major, asks you to define and discuss the nature of a liability. Assist him by preparing a definition of a liability and by explaining to him what you believe are the elements or factors inherent in the concept of a liability.
3. Why is the liabilities section of the balance sheet of primary significance to bankers?
4. How are current liabilities related by definition to current assets? How are current liabilities related to a company’s operating cycle?
5. Leon Wight, a newly hired loan analyst, is examining the current liabilities of a corporate loan applicant. He observes that unearned revenues have declined in the current year compared to the prior year. Is this a positive indicator about the client’s liquidity? Explain.
6. How is present value related to the concept of a liability?
7. What is the nature of a “discount” on notes payable?
8. How should a debt callable by the creditor be reported in the debtor’s financial statements?
9. Under what conditions should a short-term obligation be excluded from current liabilities?
10. What evidence is necessary to demonstrate the ability to consummate the refinancing of short-term debt?
11. Discuss the accounting treatment or disclosure that should be accorded a declared but unpaid cash dividend; an accumulated but undeclared dividend on cumulative preferred stock; a stock dividend distributable.
12. How does unearned revenue arise? Why can it be classified properly as a current liability? Give several examples of business activities that result in unearned revenues.
13. What are compensated absences?
14. Under what conditions must an employer accrue a liability for the cost of compensated absences?
Chapter 13 Current Liabilities and Contingencies

15. Under what conditions is an employer required to accrue a liability for sick pay? Under what conditions is an employer permitted but not required to accrue a liability for sick pay?

16. Faith Battle operates a health food store, and she has been the only employee. Her business is growing, and she is considering hiring some additional staff to help her in the store. Explain to her the various payroll deductions that she will have to account for, including their potential impact on her financial statements, if she hires additional staff.

17. Define (a) a contingency and (b) a contingent liability.

18. Under what conditions should a contingent liability be recorded?

19. Distinguish between a current liability and a contingent liability. Give two examples of each type.

20. How are the terms “probable,” “reasonably possible,” and “remote” related to contingent liabilities?


22. Grant Company has had a record-breaking year in terms of growth in sales and profitability. However, market research indicates that it will experience operating losses in two of its major businesses next year. The controller has proposed that the company record a provision for these future losses this year, since it can afford to take the charge and still show good results. Advise the controller on the appropriateness of this charge.

23. How does the expense warranty approach differ from the sales warranty approach?

24. Southeast Airlines Inc. awards members of its Flightline program a second ticket at half price, valid for 2 years anywhere on its flight system, when a full-price ticket is purchased. How would you account for the full-fare and half-fare tickets?

25. Pacific Airlines Co. awards members of its Frequent Fliers Club one free round-trip ticket, anywhere on its flight system, for every 50,000 miles flown on its planes. How would you account for the free ticket award?

26. When must a company recognize an asset retirement obligation?

27. Should a liability be recorded for risk of loss due to lack of insurance coverage? Discuss.

28. What factors must be considered in determining whether or not to record a liability for pending litigation? For threatened litigation?

29. Within the current liabilities section, how do you believe the accounts should be listed? Defend your position.

30. How does the acid-test ratio differ from the current ratio? How are they similar?

31. When should liabilities for each of the following items be recorded on the books of an ordinary business corporation?
   (a) Acquisition of goods by purchase on credit.
   (b) Officers’ salaries.
   (c) Special bonus to employees.
   (d) Dividends.
   (e) Purchase commitments.

BRIEF EXERCISES

BE13-1 Roley Corporation uses a periodic inventory system and the gross method of accounting for purchase discounts. On July 1, Roley purchased $60,000 of inventory, terms 2/10, n/30, FOB shipping point. Roley paid freight costs of $1,200. On July 3, Roley returned damaged goods and received credit of $6,000. On July 10, Roley paid for the goods. Prepare all necessary journal entries for Roley.

BE13-2 Upland Company borrowed $40,000 on November 1, 2012, by signing a $40,000, 9%, 3-month note. Prepare Upland’s November 1, 2012, entry; the December 31, 2012, annual adjusting entry; and the February 1, 2013, entry.


BE13-4 At December 31, 2012, Burr Corporation owes $500,000 on a note payable due February 15, 2013. (a) If Burr refinances the obligation by issuing a long-term note on February 14 and using the proceeds to pay off the note due February 15, how much of the $500,000 should be reported as a current liability at December 31, 2012? (b) If Burr pays off the note on February 15, 2013, and then borrows $1,000,000 on a long-term basis on March 1, how much of the $500,000 should be reported as a current liability at December 31, 2012, the end of the fiscal year?

BE13-5 Sport Pro Magazine sold 12,000 annual subscriptions on August 1, 2012, for $18 each. Prepare Sport Pro’s August 1, 2012, journal entry and the December 31, 2012, annual adjusting entry.
BE13-6 Dillons Corporation made credit sales of $30,000 which are subject to 6% sales tax. The corporation also made cash sales which totaled $20,670 including the 6% sales tax. (a) Prepare the entry to record Dillons’ credit sales. (b) Prepare the entry to record Dillons’ cash sales.

BE13-7 Lexington Corporation’s weekly payroll of $24,000 included FICA taxes withheld of $1,836, federal taxes withheld of $2,990, state taxes withheld of $920, and insurance premiums withheld of $250. Prepare the journal entry to record Lexington’s payroll.

BE13-8 Kasten Inc. provides paid vacations to its employees. At December 31, 2012, 30 employees have each earned 2 weeks of vacation time. The employees’ average salary is $500 per week. Prepare Kasten’s December 31, 2012, adjusting entry.

BE13-9 Mayaguez Corporation provides its officers with bonuses based on net income. For 2012, the bonuses total $350,000 and are paid on February 15, 2013. Prepare Mayaguez’s December 31, 2012, adjusting entry and the February 15, 2013, entry.

BE13-10 Scorcese Inc. is involved in a lawsuit at December 31, 2012. (a) Prepare the December 31 entry assuming it is probable that Scorcese will be liable for $900,000 as a result of this suit. (b) Prepare the December 31 entry, if any, assuming it is not probable that Scorcese will be liable for any payment as a result of this suit.

BE13-11 Buchanan Company recently was sued by a competitor for patent infringement. Attorneys have determined that it is probable that Buchanan will lose the case and that a reasonable estimate of damages to be paid by Buchanan is $300,000. In light of this case, Buchanan is considering establishing a $100,000 self-insurance allowance. What entry(ies), if any, should Buchanan record to recognize this loss contingency?

BE13-12 Calaf’s Drillers erects and places into service an off-shore oil platform on January 1, 2013, at a cost of $10,000,000. Calaf is legally required to dismantle and remove the platform at the end of its useful life in 10 years. Calaf estimates it will cost $1,000,000 to dismantle and remove the platform at the end of its useful life in 10 years. (The fair value at January 1, 2013, of the dismantle and removal costs is $450,000.) Prepare the entry to record the asset retirement obligation.

BE13-13 Streep Factory provides a 2-year warranty with one of its products which was first sold in 2012. In that year, Streep spent $70,000 servicing warranty claims. At year-end, Streep estimates that an additional $400,000 will be spent in the future to service warranty claims related to 2012 sales. Prepare Streep’s journal entry to record the $70,000 expenditure, and the December 31 adjusting entry.

BE13-14 Leppard Corporation sells DVD players. The corporation also offers its customers a 2-year warranty contract. During 2012, Leppard sold 20,000 warranty contracts at $99 each. The corporation spent $180,000 servicing warranties during 2012, and it estimates that an additional $900,000 will be spent in the future to service the warranties. Prepare Leppard’s journal entries for (a) the sale of contracts, (b) the cost of servicing the warranties, and (c) the recognition of warranty revenue.

BE13-15 Wynn Company offers a set of building blocks to customers who send in 3 UPC codes from Wynn cereal, along with 50¢. The block sets cost Wynn $1.10 each to purchase and 60¢ each to mail to customers. During 2012, Wynn sold 1,200,000 boxes of cereal. The company expects 30% of the UPC codes to be sent in. During 2012, 120,000 UPC codes were redeemed. Prepare Wynn’s December 31, 2012, adjusting entry.

EXERCISES

1 BE13-1 (Balance Sheet Classification of Various Liabilities) How would each of the following items be reported on the balance sheet?
   (a) Accrued vacation pay.
   (b) Estimated taxes payable.
   (c) Service warranties on appliance sales.
   (d) Bank overdraft.
   (e) Personal injury claim pending.
   (f) Unpaid bonus to officers.
   (g) Deposit received from customer to guarantee performance of a contract.
   (h) Sales taxes payable.
   (i) Gift certificates sold to customers but not yet redeemed.
   (j) Premium offers outstanding.
   (k) Discount on notes payable.
   (l) Employee payroll deductions unremitted.
   (m) Current maturities of long-term debts to be paid from current assets.
   (n) Cash dividends declared but unpaid.
   (o) Dividends in arrears on preferred stock.
   (p) Loans from officers.
Chapter 13 Current Liabilities and Contingencies

E13-2 (Accounts and Notes Payable) The following are selected 2012 transactions of Darby Corporation.

Sept. 1 Purchased inventory from Orion Company on account for $50,000. Darby records purchases gross and uses a periodic inventory system.

Oct. 1 Issued a $50,000, 12-month, 8% note to Orion in payment of account.

Oct. 1 Borrowed $75,000 from the Shore Bank by signing a 12-month, zero-interest-bearing $81,000 note.

Instructions
(a) Prepare journal entries for the selected transactions above.
(b) Prepare adjusting entries at December 31.
(c) Compute the total net liability to be reported on the December 31 balance sheet for:
   (1) The interest-bearing note.
   (2) The zero-interest-bearing note.

E13-3 (Refinancing of Short-Term Debt) On December 31, 2012, Alexander Company had $1,200,000 of short-term debt in the form of notes payable due February 2, 2013. On January 21, 2013, the company issued 25,000 shares of its common stock for $36 per share, receiving $900,000 proceeds after brokerage fees and other costs of issuance. On February 2, 2013, the proceeds from the stock sale, supplemented by an additional $300,000 cash, are used to liquidate the $1,200,000 debt. The December 31, 2012, balance sheet is issued on February 23, 2013.

Instructions
Show how the $1,200,000 of short-term debt should be presented on the December 31, 2012, balance sheet, including note disclosure.

E13-4 (Refinancing of Short-Term Debt) On December 31, 2012, Santana Company has $7,000,000 of short-term debt in the form of notes payable to Golden State Bank due in 2013. On January 28, 2013, Santana enters into a refinancing agreement with Golden that will permit it to borrow up to 60% of the gross amount of its accounts receivable. Receivables are expected to range between a low of $5,000,000 in May to a high of $8,000,000 in October during the year 2013. The interest cost of the maturing short-term debt is 15%, and the new agreement calls for a fluctuating interest rate at 1% above the prime rate on notes due in 2017. Santana’s December 31, 2012, balance sheet is issued on February 15, 2013.

Instructions
Prepare a partial balance sheet for Santana at December 31, 2012, showing how its $7,000,000 of short-term debt should be presented, including footnote disclosure.

E13-5 (Compensated Absences) Matthewson Company began operations on January 2, 2012. It employs 9 individuals who work 8-hour days and are paid hourly. Each employee earns 10 paid vacation days and 6 paid sick days annually. Vacation days may be taken after January 15 of the year following the year in which they are earned. Sick days may be taken as soon as they are earned; unused sick days accumulate. Additional information is as follows.

<table>
<thead>
<tr>
<th>Actual Hourly Wage Rate</th>
<th>Vacation Days Used by Each Employee</th>
<th>Sick Days Used by Each Employee</th>
</tr>
</thead>
</table>

Matthewson Company has chosen to accrue the cost of compensated absences at rates of pay in effect during the period when earned and to accrue sick pay when earned.

Instructions
(a) Prepare journal entries to record transactions related to compensated absences during 2012 and 2013.
(b) Compute the amounts of any liability for compensated absences that should be reported on the balance sheet at December 31, 2012 and 2013.

E13-6 (Compensated Absences) Assume the facts in E13-5, except that Matthewson Company has chosen not to accrue paid sick leave until used, and has chosen to accrue vacation time at expected future rates of pay without discounting. The company used the following projected rates to accrue vacation time.

<table>
<thead>
<tr>
<th>Year in Which Vacation Time Was Earned</th>
<th>Projected Future Pay Rates Used to Accrue Vacation Pay</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012 $12.90</td>
<td></td>
</tr>
<tr>
<td>2013 13.70</td>
<td></td>
</tr>
</tbody>
</table>
Instructions
(a) Prepare journal entries to record transactions related to compensated absences during 2012 and 2013.
(b) Compute the amounts of any liability for compensated absences that should be reported on the balance sheet at December 31, 2012 and 2013.

1 E13-7 (Adjusting Entry for Sales Tax) During the month of June, Danielle’s Boutique had cash sales of $265,000 and credit sales of $153,700, both of which include the 6% sales tax that must be remitted to the state by July 15.

Instructions
Prepare the adjusting entry that should be recorded to fairly present the June 30 financial statements.

3 E13-8 (Payroll Tax Entries) The payroll of Delaney Company for September 2012 is as follows.

<table>
<thead>
<tr>
<th>Payroll</th>
<th>Wages Due</th>
<th>Amount Subject to Payroll Taxes</th>
<th>Unemployment Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>FICA</td>
<td>Federal</td>
</tr>
<tr>
<td>Factory</td>
<td>$140,000</td>
<td>$140,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>Sales</td>
<td>32,000</td>
<td>32,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Administrative</td>
<td>36,000</td>
<td>36,000</td>
<td>—</td>
</tr>
<tr>
<td>Total</td>
<td>$208,000</td>
<td>$208,000</td>
<td>$44,000</td>
</tr>
</tbody>
</table>

At this point in the year, some employees have already received wages in excess of those to which payroll taxes apply. Assume that the state unemployment tax is 2.5%. The FICA rate is 7.65% on an employee’s wages to $106,800 and 1.45% in excess of $106,800. Of the $208,000 wages subject to FICA tax, $20,000 of the taxes apply. Assume that the current FICA tax is 7.65% on an employee’s wages to $106,800 and 1.45% in excess of $106,800. No employee for Delaney makes more than $125,000. The federal unemployment tax rate is 0.8% after state credit.

Instructions
(a) Prepare a schedule showing the employer’s total cost of wages for November by function.
(b) Prepare the necessary journal entries if the wages and salaries paid and the employer payroll taxes are recorded separately.

3 E13-9 (Payroll Tax Entries) Allison Hardware Company’s payroll for November 2012 is summarized below.

Prepare 2012 entries for Selzer assuming that the warranties are not an integral part of the sale.

5 E13-10 (Warranties) Winslow Company sold 150 color laser copiers in 2012 for $4,000 apiece, together with a one-year warranty. Maintenance on each copier during the warranty period averages $300.

Instructions
(a) Prepare entries to record the sale of the copiers and the related warranty costs, assuming that the accrual method is used. Actual warranty costs incurred in 2012 were $17,000.
(b) On the basis of the data above, prepare the appropriate entries, assuming that the cash-basis method is used.

5 E13-11 (Warranties) Selzer Equipment Company sold 500 Rollomatics during 2012 at $6,000 each. During 2012, Selzer spent $30,000 servicing the 2-year warranties that accompany the Rollomatic. All applicable transactions are on a cash basis.

Instructions
(a) Prepare 2012 entries for Selzer using the expense warranty approach. Assume that Selzer estimates the total cost of servicing the warranties will be $120,000 for 2 years.
(b) Prepare 2012 entries for Selzer assuming that the warranties are not an integral part of the sale. Assume that of the sales total, $160,000 relates to sales of warranty contracts. Selzer estimates the total cost of servicing the warranties will be $120,000 for 2 years. Estimate revenues earned on the basis of costs incurred and estimated costs.
758 Chapter 13 Current Liabilities and Contingencies

E13-12 (Premium Entries) Moleski Company includes 1 coupon in each box of soap powder that it packs, and 10 coupons are redeemable for a premium (a kitchen utensil). In 2012, Moleski Company purchased 8,800 premiums at 90 cents each and sold 120,000 boxes of soap powder at $3.30 per box; 44,000 coupons were presented for redemption in 2012. It is estimated that 60% of the coupons will eventually be presented for redemption.

Instructions
Prepare all the entries that would be made relative to sales of soap powder and to the premium plan in 2012.

E13-13 (Contingencies) Presented below are three independent situations. Answer the question at the end of each situation.

1. During 2012, Maverick Inc. became involved in a tax dispute with the IRS. Maverick’s attorneys have indicated that they believe it is probable that Maverick will lose this dispute. They also believe that Maverick will have to pay the IRS between $800,000 and $1,400,000. After the 2012 financial statements were issued, the case was settled with the IRS for $1,200,000. What amount, if any, should be reported as a liability for this contingency as of December 31, 2012?

2. On October 1, 2012, Holmgren Chemical was identified as a potentially responsible party by the Environmental Protection Agency. Holmgren’s management along with its counsel have concluded that it is probable that Holmgren will be responsible for damages, and a reasonable estimate of these damages is $6,000,000. Holmgren’s insurance policy of $9,000,000 has a deductible clause of $500,000. How should Holmgren Chemical report this information in its financial statements at December 31, 2012?

3. Shinobi Inc. had a manufacturing plant in Darfur, which was destroyed in the civil war. It is not certain who will compensate Shinobi for this destruction, but Shinobi has been assured by governmental officials that it will receive a definite amount for this plant. The amount of the compensation will be less than the fair value of the plant but more than its book value. How should the contingency be reported in the financial statements of Shinobi Inc.?

E13-14 (Asset Retirement Obligation) Bassinger Company purchases an oil tanker depot on January 1, 2012, at a cost of $600,000. Bassinger expects to operate the depot for 10 years, at which time it is legally required to dismantle the depot and remove the underground storage tanks. It is estimated that it will cost $70,000 to dismantle the depot and remove the tanks at the end of the depot’s useful life.

Instructions
(a) Prepare the journal entries to record the depot (considered a plant asset) and the asset retirement obligation for the depot on January 1, 2012. Based on an effective-interest rate of 6%, the fair value of the asset retirement obligation on January 1, 2012, is $39,087.
(b) Prepare any journal entries required for the depot and the asset retirement obligation at December 31, 2012. Bassinger uses straight-line depreciation; the estimated residual value for the depot is zero.
(c) On December 31, 2021, Bassinger pays a demolition firm to dismantle the depot and remove the tanks at a price of $80,000. Prepare the journal entry for the settlement of the asset retirement obligation.

E13-15 (Premiums) Presented below are three independent situations.

1. Marquart Stamp Company records stamp service revenue and provides for the cost of redemptions in the year stamps are sold to licensees. Marquart’s past experience indicates that only 80% of the stamps sold to licensees will be redeemed. Marquart’s liability for stamp redemptions was $13,500,000 at December 31, 2011. Additional information for 2012 is as follows.

| Stamp service revenue from stamps sold to licensees | $9,500,000 |
| Cost of redemptions (stamps sold prior to 1/1/12) | 6,000,000 |

If all the stamps sold in 2012 were presented for redemption in 2013, the redemption cost would be $5,200,000. What amount should Marquart report as a liability for stamp redemptions at December 31, 2012?

2. In packages of its products, Wiseman Inc. includes coupons that may be presented at retail stores to obtain discounts on other Wiseman products. Retailers are reimbursed for the face amount of coupons redeemed plus 10% of that amount for handling costs. Wiseman honors requests for coupon redemption by retailers up to 3 months after the consumer expiration date. Wiseman estimates that 60% of all coupons issued will ultimately be redeemed. Information relating to coupons issued by Wiseman during 2012 is as follows.

| Consumer expiration date | 12/31/12 |
| Total face amount of coupons issued | $850,000 |
| Total payments to retailers as of 12/31/12 | $390,000 |
What amount should Wiseman report as a liability for unredeemed coupons at December 31, 2012?

3. Newell Company sold 600,000 boxes of pie mix under a new sales promotional program. Each box contains one coupon, which when submitted with $4.00, entitles the customer to a baking pan. Newell pays $6.00 per pan and $0.50 for handling and shipping. Newell estimates that 70% of the coupons will be redeemed, even though only 250,000 coupons had been processed during 2012. What amount should Newell report as a liability for unredeemed coupons at December 31, 2012? (AICPA adapted)

E13-16 (Financial Statement Impact of Liability Transactions) Presented below is a list of possible transactions:

1. Purchased inventory for $80,000 on account (assume perpetual system is used).
2. Issued an $80,000 note payable in payment on account (see item 1 above).
3. Recorded accrued interest on the note from item 2 above.
4. Borrowed $100,000 from the bank by signing a 6-month, $112,000, zero-interest-bearing note.
5. Recognized 4 months’ interest expense on the note from item 4 above.
6. Recorded cash sales of $75,260, which includes 6% sales tax.
7. Recorded wage expense of $35,000. The cash paid was $25,000; the difference was due to various amounts withheld.
8. Recorded employer’s payroll taxes.
9. Accrued accumulated vacation pay.
10. Recorded an asset retirement obligation.
11. Recorded bonuses due to employees.
12. Recorded sales of product and related warranties (assume sales warranty approach).
13. Accrued warranty expense (assume expense warranty approach).
14. Paid warranty costs that were accrued in item 13 above.
15. Recorded a contingent loss on a lawsuit that the company will probably lose.
16. Paid warranty costs under contracts from item 12.
17. Recognized warranty revenue (see item 12).
18. Recorded estimated liability for premium claims outstanding.

Instructions
Set up a table using the format shown below and analyze the effect of the 18 transactions on the financial statement categories indicated.

<table>
<thead>
<tr>
<th>#</th>
<th>Assets</th>
<th>Liabilities</th>
<th>Owners’ Equity</th>
<th>Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Use the following code:
I: Increase   D: Decrease   NE: No net effect

E13-17 (Ratio Computations and Discussion) Costner Company has been operating for several years, and on December 31, 2012, presented the following balance sheet.

<table>
<thead>
<tr>
<th>COSTNER COMPANY</th>
</tr>
</thead>
<tbody>
<tr>
<td>BALANCE SHEET</td>
</tr>
<tr>
<td>DECEMBER 31, 2012</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cash</th>
<th>$ 40,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Receivables</td>
<td>75,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>95,000</td>
</tr>
<tr>
<td>Plant assets (net)</td>
<td>220,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>$ 70,000</td>
</tr>
<tr>
<td>Mortgage payable</td>
<td>140,000</td>
</tr>
<tr>
<td>Common stock ($1 par)</td>
<td>160,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>60,000</td>
</tr>
</tbody>
</table>

$430,000   $430,000

The net income for 2012 was $25,000. Assume that total assets are the same in 2011 and 2012.

Instructions
Compute each of the following ratios. For each of the four, indicate the manner in which it is computed and its significance as a tool in the analysis of the financial soundness of the company.

(a) Current ratio.  (c) Debt to total assets.
(b) Acid-test ratio.  (d) Rate of return on assets.
760 Chapter 13 Current Liabilities and Contingencies

6 E13-18 (Ratio Computations and Analysis) Vogue Company’s condensed financial statements provide the following information.

**VOGUE COMPANY BALANCE SHEET**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 52,000</td>
<td>$ 60,000</td>
</tr>
<tr>
<td>Accounts receivable (net)</td>
<td>158,000</td>
<td>80,000</td>
</tr>
<tr>
<td>Short-term investments</td>
<td>80,000</td>
<td>40,000</td>
</tr>
<tr>
<td>Inventory</td>
<td>440,000</td>
<td>360,000</td>
</tr>
<tr>
<td>Prepaid expenses</td>
<td>3,000</td>
<td>7,000</td>
</tr>
<tr>
<td><strong>Total current assets</strong></td>
<td><strong>$ 733,000</strong></td>
<td><strong>$ 547,000</strong></td>
</tr>
<tr>
<td>Property, plant, and equipment (net)</td>
<td>897,000</td>
<td>853,000</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>$1,630,000</strong></td>
<td><strong>$1,400,000</strong></td>
</tr>
<tr>
<td>Current liabilities</td>
<td>240,000</td>
<td>160,000</td>
</tr>
<tr>
<td>Bonds payable</td>
<td>400,000</td>
<td>400,000</td>
</tr>
<tr>
<td>Common stockholders’ equity</td>
<td>990,000</td>
<td>840,000</td>
</tr>
<tr>
<td><strong>Total liabilities and stockholders’ equity</strong></td>
<td><strong>$1,630,000</strong></td>
<td><strong>$1,400,000</strong></td>
</tr>
</tbody>
</table>

**INCOME STATEMENT FOR THE YEAR ENDED 2012**

Sales $1,640,000  
Cost of goods sold (800,000)  
**Gross profit** 840,000  
Selling and administrative expenses (480,000)  
Interest expense (40,000)  
**Net income** $ 320,000  

**Instructions**

(a) Determine the following for 2012.
   (1) Current ratio at December 31.
   (2) Acid-test ratio at December 31.
   (3) Accounts receivable turnover.
   (4) Inventory turnover.
   (5) Rate of return on assets.
   (6) Profit margin on sales.

(b) Prepare a brief evaluation of the financial condition of Vogue Company and of the adequacy of its profits.

6 E13-19 (Ratio Computations and Effect of Transactions) Presented below is information related to Leland Inc.

**LELAND INC. BALANCE SHEET DECEMBER 31, 2012**

<table>
<thead>
<tr>
<th></th>
<th>$</th>
<th>$</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 45,000</td>
<td>$ 50,000</td>
</tr>
<tr>
<td>Receivables</td>
<td>$110,000</td>
<td>Accounts payable</td>
</tr>
<tr>
<td>Less: Allowance</td>
<td>15,000</td>
<td>Accrued liabilities</td>
</tr>
<tr>
<td>Inventory</td>
<td>170,000</td>
<td>Common stock (par $5)</td>
</tr>
<tr>
<td>Prepaid insurance</td>
<td>8,000</td>
<td>Retained earnings</td>
</tr>
<tr>
<td>Land</td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td>Equipment (net)</td>
<td>150,000</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$488,000</strong></td>
<td><strong>$488,000</strong></td>
</tr>
</tbody>
</table>
LELAND INC.
INCOME STATEMENT
FOR THE YEAR ENDED DECEMBER 31, 2012

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$1,400,000</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td></td>
</tr>
<tr>
<td>Inventory, Jan. 1, 2012</td>
<td>$200,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>790,000</td>
</tr>
<tr>
<td>Cost of goods available for sale</td>
<td>990,000</td>
</tr>
<tr>
<td>Inventory, Dec. 31, 2012</td>
<td>(170,000)</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>820,000</td>
</tr>
<tr>
<td>Gross profit on sales</td>
<td>580,000</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>370,000</td>
</tr>
<tr>
<td>Net income</td>
<td>$ 210,000</td>
</tr>
</tbody>
</table>

Instructions
(a) Compute the following ratios or relationships of Leland Inc. Assume that the ending account balances are representative unless the information provided indicates differently.
(1) Current ratio.
(2) Inventory turnover.
(3) Receivables turnover.
(4) Earnings per share.
(5) Profit margin on sales.
(6) Rate of return on assets on December 31, 2012.
(b) Indicate for each of the following transactions whether the transaction would improve, weaken, or have no effect on the current ratio of Leland Inc. at December 31, 2012.
(1) Write off an uncollectible account receivable, $2,200.
(2) Repurchase common stock for cash.
(3) Pay $40,000 on notes payable (short-term).
(4) Collect $23,000 on accounts receivable.
(5) Buy equipment on account.
(6) Give an existing creditor a short-term note in settlement of account.

See the book’s companion website, www.wiley.com/college/kieso, for a set of B Exercises.

PROBLEMS

P13-1 (Current Liability Entries and Adjustments) Described below are certain transactions of Edwardson Corporation. The company uses the periodic inventory system.

1. On February 2, the corporation purchased goods from Martin Company for $70,000 subject to cash discount terms of 2/10, n/30. Purchases and accounts payable are recorded by the corporation at net amounts after cash discounts. The invoice was paid on February 26.
2. On April 1, the corporation bought a truck for $50,000 from General Motors Company, paying $4,000 in cash and signing a one-year, 12% note for the balance of the purchase price.
3. On May 1, the corporation borrowed $83,000 from Chicago National Bank by signing a $92,000 zero-interest-bearing note due one year from May 1.
4. On August 1, the board of directors declared a $300,000 cash dividend that was payable on September 10 to stockholders of record on August 31.

Instructions
(a) Make all the journal entries necessary to record the transactions above using appropriate dates.
(b) Edwardson Corporation’s year-end is December 31. Assuming that no adjusting entries relative to the transactions above have been recorded, prepare any adjusting journal entries concerning interest that are necessary to present fair financial statements at December 31. Assume straight-line amortization of discounts.
Chapter 13 Current Liabilities and Contingencies

P13-2 (Liability Entries and Adjustments) Listed below are selected transactions of Schultz Department Store for the current year ending December 31.

1. On December 5, the store received $500 from the Jackson Players as a deposit to be returned after certain furniture to be used in stage production was returned on January 15.
2. During December, cash sales totaled $798,000, which includes the 5% sales tax that must be remitted to the state by the fifteenth day of the following month.
3. On December 10, the store purchased for cash three delivery trucks for $120,000. The trucks were purchased in a state that applies a 5% sales tax.
4. The store determined it will cost $100,000 to restore the area (considered a land improvement) surrounding one of its store parking lots, when the store is closed in 2 years. Schultz estimates the fair value of the obligation at December 31 is $84,000.

Instructions
Prepare all the journal entries necessary to record the transactions noted above as they occurred and any adjusting journal entries relative to the transactions that would be required to present fair financial statements at December 31. Date each entry. For simplicity, assume that adjusting entries are recorded only once a year on December 31.

P13-3 (Payroll Tax Entries) Cedarville Company pays its office employee payroll weekly. Below is a partial list of employees and their payroll data for August. Because August is their vacation period, vacation pay is also listed.

<table>
<thead>
<tr>
<th>Employee</th>
<th>Earnings to July 31</th>
<th>Weekly Pay</th>
<th>Vacation Pay to Be Received in August</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mark Hamill</td>
<td>$4,200</td>
<td>$200</td>
<td>-</td>
</tr>
<tr>
<td>Karen Robbins</td>
<td>3,500</td>
<td>150</td>
<td>$300</td>
</tr>
<tr>
<td>Brent Kirk</td>
<td>2,700</td>
<td>110</td>
<td>220</td>
</tr>
<tr>
<td>Alec Guinness</td>
<td>7,400</td>
<td>250</td>
<td>-</td>
</tr>
<tr>
<td>Ken Sprouse</td>
<td>6,000</td>
<td>330</td>
<td>660</td>
</tr>
</tbody>
</table>

Assume that the federal income tax withheld is 10% of wages. Union dues withheld are 2% of wages. Vacations are taken the second and third weeks of August by Robbins, Kirk, and Sprouse. The state unemployment tax rate is 2.5% and the federal is 0.8%, both on a $7,000 maximum. The FICA rate is 7.65% on employee and employer on a maximum of $106,800 per employee. In addition, a 1.45% rate is charged both employer and employee for an employee’s wages in excess of $106,800.

Instructions
Make the journal entries necessary for each of the four August payrolls. The entries for the payroll and for the company’s liability are made separately. Also make the entry to record the monthly payment of accrued payroll liabilities.

P13-4 (Payroll Tax Entries) Below is a payroll sheet for Otis Import Company for the month of September 2012. The company is allowed a 1% unemployment compensation rate by the state; the federal unemployment tax rate is 0.8% and the maximum for both is $7,000. Assume a 10% federal income tax rate for all employees and a 7.65% FICA tax on employee and employer on a maximum of $106,800. In addition, a 1.45% rate is charged both employer and employee for an employee’s wages in excess of $106,800 per employee.

<table>
<thead>
<tr>
<th>Name</th>
<th>Earnings to Aug. 31</th>
<th>September Earnings</th>
<th>Income Tax Withholding</th>
<th>FICA</th>
<th>State U.C.</th>
<th>Federal U.C.</th>
</tr>
</thead>
<tbody>
<tr>
<td>B.D. Williams</td>
<td>$6,800</td>
<td>$800</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>D. Raye</td>
<td>6,500</td>
<td>700</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>K. Baker</td>
<td>7,600</td>
<td>1,100</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>F. Lopez</td>
<td>13,600</td>
<td>1,900</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Daniels</td>
<td>107,000</td>
<td>13,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>B. Kingston</td>
<td>112,000</td>
<td>16,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Instructions
(a) Complete the payroll sheet and make the necessary entry to record the payment of the payroll.
(b) Make the entry to record the payroll tax expenses of Otis Import Company.
(c) Make the entry to record the payment of the payroll liabilities created. Assume that the company pays all payroll liabilities at the end of each month.
P13-5 (Warranties, Accrual, and Cash Basis) Brooks Corporation sells computers under a 2-year warranty contract that requires the corporation to replace defective parts and to provide the necessary repair labor. During 2012, the corporation sells for cash 400 computers at a unit price of $2,500. On the basis of past experience, the 2-year warranty costs are estimated to be $155 for parts and $185 for labor per unit. (For simplicity, assume that all sales occurred on December 31, 2012.) The warranty is not sold separately from the computer.

Instructions
(a) Record any necessary journal entries in 2012, applying the cash-basis method.
(b) Record any necessary journal entries in 2012, applying the expense warranty accrual method.
(c) What liability relative to these transactions would appear on the December 31, 2012, balance sheet and how would it be classified if the cash-basis method is applied?
(d) What liability relative to these transactions would appear on the December 31, 2012, balance sheet and how would it be classified if the expense warranty accrual method is applied?

In 2013, the actual warranty costs to Brooks Corporation were $21,400 for parts and $39,900 for labor.
(e) Record any necessary journal entries in 2013, applying the cash-basis method.
(f) Record any necessary journal entries in 2013, applying the expense warranty accrual method.

P13-6 (Extended Warranties) Dos Passos Company sells televisions at an average price of $900 and also offers to each customer a separate 3-year warranty contract for $90 that requires the company to perform periodic services and to replace defective parts. During 2012, the company sold 300 televisions and 270 warranty contracts for cash. It estimates the 3-year warranty costs as $20 for parts and $40 for labor and accounts for warranties separately. Assume sales occurred on December 31, 2012, and straight-line recognition of warranty revenues occurs.

Instructions
(a) Record any necessary journal entries in 2012.
(b) What liability relative to these transactions would appear on the December 31, 2012, balance sheet and how would it be classified?

In 2013, Dos Passos Company incurred actual costs relative to 2012 television warranty sales of $2,000 for parts and $4,000 for labor.
(c) Record any necessary journal entries in 2013 relative to 2012 television warranties.
(d) What amounts relative to the 2012 television warranties would appear on the December 31, 2013, balance sheet and how would they be classified?

P13-7 (Warranties, Accrual, and Cash Basis) Alvarado Company sells a machine for $7,400 under a 12-month warranty agreement that requires the company to replace all defective parts and to provide the repair labor at no cost to the customers. With sales being made evenly throughout the year, the company sells 600 machines in 2012 (warranty expense is incurred half in 2012 and half in 2013). As a result of product testing, the company estimates that the warranty cost is $390 per machine ($170 parts and $220 labor).

Instructions
Assuming that actual warranty costs are incurred exactly as estimated, what journal entries would be made relative to the following facts?

(a) Under application of the expense warranty accrual method for:
   (1) Sale of machinery in 2012.
   (2) Warranty costs incurred in 2012.
   (4) Warranty costs incurred in 2013.
(b) Under application of the cash-basis method for:
   (1) Sale of machinery in 2012.
   (2) Warranty costs incurred in 2012.
   (4) Warranty costs incurred in 2013.
(c) What amount, if any, is disclosed in the balance sheet as a liability for future warranty costs as of December 31, 2012, under each method?
(d) Which method best reflects the income in 2012 and 2013 of Alvarado Company? Why?

P13-8 (Premium Entries) To stimulate the sales of its Alladin breakfast cereal, Loptien Company places 1 coupon in each box. Five coupons are redeemable for a premium consisting of a children’s hand puppet. In 2013, the company purchases 40,000 puppets at $1.50 each and sells 480,000 boxes of Alladin at $3.75 a box.
Chapter 13 Current Liabilities and Contingencies

From its experience with other similar premium offers, the company estimates that 40% of the coupons issued will be mailed back for redemption. During 2013, 115,000 coupons are presented for redemption.

Instructions
Prepare the journal entries that should be recorded in 2013 relative to the premium plan.

P13-9 (Premium Entries and Financial Statement Presentation) Sycamore Candy Company offers a CD single as a premium for every five candy bar wrappers presented by customers together with $2.50. The candy bars are sold by the company to distributors for 30 cents each. The purchase price of each CD to the company is $2.25; in addition, it costs 50 cents to mail each CD. The results of the premium plan for the years 2012 and 2013 are as follows. (All purchases and sales are for cash.)

<table>
<thead>
<tr>
<th></th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>CDs purchased</td>
<td>250,000</td>
<td>330,000</td>
</tr>
<tr>
<td>Candy bars sold</td>
<td>2,895,400</td>
<td>2,743,600</td>
</tr>
<tr>
<td>Wrappers redeemed</td>
<td>1,200,000</td>
<td>1,500,000</td>
</tr>
<tr>
<td>2012 wrappers expected to be redeemed in 2013</td>
<td>290,000</td>
<td></td>
</tr>
<tr>
<td>2013 wrappers expected to be redeemed in 2014</td>
<td></td>
<td>350,000</td>
</tr>
</tbody>
</table>

Instructions
(a) Prepare the journal entries that should be made in 2012 and 2013 to record the transactions related to the premium plan of the Sycamore Candy Company.
(b) Indicate the account names, amounts, and classifications of the items related to the premium plan that would appear on the balance sheet and the income statement at the end of 2012 and 2013.

P13-10 (Loss Contingencies: Entries and Essay) On November 24, 2012, 26 passengers on Windsor Airlines Flight No. 901 were injured upon landing when the plane skidded off the runway. Personal injury suits for damages totaling $9,000,000 were filed on January 11, 2013, against the airline by 18 injured passengers. The airline carries no insurance. Legal counsel has studied each suit and advised Windsor that it can reasonably expect to pay 60% of the damages claimed. The financial statements for the year ended December 31, 2012, were issued February 27, 2013.

Instructions
(a) Prepare any disclosures and journal entries required by the airline in preparation of the December 31, 2012, financial statements.
(b) Ignoring the Nov. 24, 2012, accident, what liability due to the risk of loss from lack of insurance coverage should Windsor Airlines record or disclose? During the past decade, the company has experienced at least one accident per year and incurred average damages of $2,200,000. Discuss fully.

P13-11 (Loss Contingencies: Entries and Essays) Polska Corporation, in preparation of its December 31, 2012, financial statements, is attempting to determine the proper accounting treatment for each of the following situations.

1. As a result of uninsured accidents during the year, personal injury suits for $350,000 and $60,000 have been filed against the company. It is the judgment of Polska’s legal counsel that an unfavorable outcome is unlikely in the $60,000 case but that an unfavorable verdict approximating $250,000 will probably result in the $350,000 case.
2. Polska Corporation owns a subsidiary in a foreign country that has a book value of $5,725,000 and an estimated fair value of $9,500,000. The foreign government has communicated to Polska its intention to expropriate the assets and business of all foreign investors. On the basis of settlements other firms have received from this same country, Polska expects to receive 40% of the fair value of its properties as final settlement.
3. Polska’s chemical product division consisting of five plants is uninsurable because of the special risk of injury to employees and losses due to fire and explosion. The year 2012 is considered one of the safest (luckiest) in the division’s history because no loss due to injury or casualty was suffered. Having suffered an average of three casualties a year during the rest of the past decade (ranging from $60,000 to $700,000), management is certain that next year the company will probably not be so fortunate.

Instructions
(a) Prepare the journal entries that should be recorded as of December 31, 2012, to recognize each of the situations above.
(b) Indicate what should be reported relative to each situation in the financial statements and accompanying notes. Explain why.

P13-12 (Warranties and Premiums) Garison Music Emporium carries a wide variety of musical instruments, sound reproduction equipment, recorded music, and sheet music. Garison uses two sales promotion techniques— warranties and premiums—to attract customers.
Musical instruments and sound equipment are sold with a one-year warranty for replacement of parts
and labor. The estimated warranty cost, based on past experience, is 2% of sales.

The premium is offered on the recorded and sheet music. Customers receive a coupon for each dollar
spent on recorded music or sheet music. Customers may exchange 200 coupons and $20 for a CD player. Gar-
son pays $32 for each CD player and estimates that 60% of the coupons given to customers will be redeemed.

Garson’s total sales for 2012 were $7,200,000—$5,700,000 from musical instruments and sound repro-
duction equipment and $1,500,000 from recorded music and sheet music. Replacement parts and labor for
warranty work totaled $164,000 during 2012. A total of 6,500 CD players used in the premium program
were purchased during the year, and there were 1,200,000 coupons redeemed in 2012.

As presented, these contingencies are not reported in accordance with GAAP, which may create problems
in issuing a favorable audit report. You feel the need to note these problems in the work papers.

You are the independent auditor engaged to audit Millay Corporation’s
December 31, 2012, financial statements. Millay manufactures household appliances. During the course of
your audit, you discovered the following contingent liabilities.

1. Millay began production of a new dishwasher in June 2012 and, by December 31, 2012, sold 120,000
to various retailers for $500 each. Each dishwasher is under a one-year warranty. The company esti-
mates that its warranty expense per dishwasher will amount to $25. At year-end, the company had
already paid out $1,000,000 in warranty expenses. Millay’s income statement shows warranty ex-
penses of $1,000,000 for 2012. Millay accounts for warranty costs on the accrual basis.

2. In response to your attorney’s letter, Morgan Sondgeroth, Esq., has informed you that Millay has
been cited for dumping toxic waste into the Kishwaukee River. Clean-up costs and fines amount to
$2,750,000. Although the case is still being contested, Sondgeroth is certain that Millay will most
probably have to pay the fine and clean-up costs. No disclosure of this situation was found in the
financial statements.

3. Millay is the defendant in a patent infringement lawsuit by Megan Drabek over Millay’s use of a
hydraulic compressor in several of its products. Sondgeroth claims that, if the suit goes against
Millay, the loss may be as much as $5,000,000; however, Sondgeroth believes the loss of this suit to be
only reasonably possible. Again, no mention of this suit is made in the financial statements.

As presented, these contingencies are not reported in accordance with GAAP, which may create problems
in issuing a favorable audit report. You feel the need to note these problems in the work papers.

Heading each page with the name of the company, balance sheet date, and a brief description of the prob-
lem, write a brief narrative for each of the above issues in the form of a memorandum to be incorporated
in the audit work papers. Explain what led to the discovery of each problem, what the problem really is,
and what you advised your client to do (along with any appropriate journal entries) in order to bring these
contingencies in accordance with GAAP.

Schmitt Company must make computations and adjusting
entries for the following independent situations at December 31, 2013.

1. Its line of amplifiers carries a 3-year warranty against defects. On the basis of past experience the
estimated warranty costs related to dollar sales are: first year after sale—2% of sales; second year
after sale—3% of sales; and third year after sale—5% of sales. Sales and actual warranty expenditures
for the first 3 years of business were:

<table>
<thead>
<tr>
<th>Year</th>
<th>Sales</th>
<th>Warranty Expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>$ 800,000</td>
<td>$ 6,500</td>
</tr>
<tr>
<td>2012</td>
<td>1,100,000</td>
<td>17,200</td>
</tr>
<tr>
<td>2013</td>
<td>1,200,000</td>
<td>62,000</td>
</tr>
</tbody>
</table>

Problems 765
766 Chapter 13 Current Liabilities and Contingencies

Instructions
Compute the amount that Schmitt Company should report as a liability in its December 31, 2013, balance sheet. Assume that all sales are made evenly throughout each year with warranty expenses also evenly spaced relative to the rates above.

2. With some of its products, Schmitt Company includes coupons that are redeemable in merchandise. The coupons have no expiration date and, in the company’s experience, 40% of them are redeemed. The liability for unredeemed coupons at December 31, 2012, was $9,000. During 2013, coupons worth $30,000 were issued, and merchandise worth $8,000 was distributed in exchange for coupons redeemed.

Instructions
Compute the amount of the liability that should appear on the December 31, 2013, balance sheet.

(AICPA adapted)

CONCEPTS FOR ANALYSIS

CA13-1 (Nature of Liabilities) Presented below is the current liabilities section of Micro Corporation.

<table>
<thead>
<tr>
<th>($000)</th>
<th>2013</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Notes payable</td>
<td>$ 68,713</td>
<td>$  7,700</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>179,496</td>
<td>101,379</td>
</tr>
<tr>
<td>Compensation to employees</td>
<td>60,312</td>
<td>31,649</td>
</tr>
<tr>
<td>Accrued liabilities</td>
<td>158,198</td>
<td>77,621</td>
</tr>
<tr>
<td>Income taxes payable</td>
<td>10,486</td>
<td>26,491</td>
</tr>
<tr>
<td>Current maturities of long-term debt</td>
<td>16,592</td>
<td>6,649</td>
</tr>
<tr>
<td>Total current liabilities</td>
<td>$493,797</td>
<td>$251,489</td>
</tr>
</tbody>
</table>

Instructions
Answer the following questions.

(a) What are the essential characteristics that make an item a liability?
(b) How does one distinguish between a current liability and a long-term liability?
(c) What are accrued liabilities? Give three examples of accrued liabilities that Micro might have.
(d) What is the theoretically correct way to value liabilities? How are current liabilities usually valued?
(e) Why are notes payable reported first in the current liabilities section?
(f) What might be the items that comprise Micro’s liability for “Compensation to employees”?

CA13-2 (Current versus Noncurrent Classification) Rodriguez Corporation includes the following items in its liabilities at December 31, 2012.

1. Notes payable, $25,000,000, due June 30, 2013.
2. Deposits from customers on equipment ordered by them from Rodriguez, $6,250,000.

Instructions
Indicate in what circumstances, if any, each of the three liabilities above would be excluded from current liabilities.

CA13-3 (Refinancing of Short-Term Debt) Dumars Corporation reports in the current liability section of its balance sheet at December 31, 2012 (its year-end), short-term obligations of $15,000,000, which includes the current portion of 12% long-term debt in the amount of $10,000,000 (matures in March 2013). Management has stated its intention to refinance the 12% debt whereby no portion of it will mature during 2013. The date of issuance of the financial statements is March 25, 2013.

Instructions
(a) Is management’s intent enough to support long-term classification of the obligation in this situation?
(b) Assume that Dumars Corporation issues $13,000,000 of 10-year debentures to the public in January 2013 and that management intends to use the proceeds to liquidate the $10,000,000 debt maturing in March 2013. Furthermore, assume that the debt maturing in March 2013 is paid from these proceeds prior to the issuance of the financial statements. Will this have any impact on the balance sheet classification at December 31, 2012? Explain your answer.
Concepts for Analysis 767

(c) Assume that Dumars Corporation issues common stock to the public in January and that management intends to entirely liquidate the $10,000,000 debt maturing in March 2013 with the proceeds of this equity securities issue. In light of these events, should the $10,000,000 debt maturing in March 2013 be included in current liabilities at December 31, 2012?

(d) Assume that Dumars Corporation, on February 15, 2013, entered into a financing agreement with a commercial bank that permits Dumars Corporation to borrow at any time through 2014 up to $15,000,000 at the bank’s prime rate of interest. Borrowings under the financing agreement mature three years after the date of the loan. The agreement is not cancelable except for violation of a provision with which compliance is objectively determinable. No violation of any provision exists at the date of issuance of the financial statements. Assume further that the current portion of long-term debt does not mature until August 2013. In addition, management intends to refinance the $10,000,000 obligation under the terms of the financial agreement with the bank, which is expected to be financially capable of honoring the agreement.

Instructions

(1) Given these facts, should the $10,000,000 be classified as current on the balance sheet at December 31, 2012?

(2) Is disclosure of the refinancing method required?

CA13-4 (Refinancing of Short-Term Debt) Andretti Inc. issued $10,000,000 of short-term commercial paper during the year 2012 to finance construction of a plant. At December 31, 2012, the corporation’s year-end, Andretti intends to refinance the commercial paper by issuing long-term debt. However, because the corporation temporarily has excess cash, in January 2013 it liquidates $3,000,000 of the commercial paper as the paper matures. In February 2013, Andretti completes an $18,000,000 long-term debt offering. Later during the month of February, it issues its December 31, 2012, financial statements. The proceeds of the long-term debt offering are to be used to replenish $3,000,000 in working capital, to pay $7,000,000 of commercial paper as it matures in March 2013, and to pay $8,000,000 of construction costs expected to be incurred later that year to complete the plant.

Instructions

(a) How should the $10,000,000 of commercial paper be classified on the December 31, 2012, January 31, 2013, and February 28, 2013, balance sheets? Give support for your answer and also consider the cash element.

(b) What would your answer be if, instead of a refinancing at the date of issuance of the financial statements, a financing agreement existed at that date?

CA13-5 (Loss Contingencies) On February 1, 2013, one of the huge storage tanks of Viking Manufacturing Company exploded. Windows in houses and other buildings within a one-mile radius of the explosion were severely damaged, and a number of people were injured. As of February 15, 2013 (when the December 31, 2012, financial statements were completed and sent to the publisher for printing and public distribution), no suits had been filed or claims asserted against the company as a consequence of the explosion. The company fully anticipates that suits will be filed and claims asserted for injuries and damages. Because the casualty was uninsured and the company considered at fault, Viking Manufacturing will have to cover the damages from its own resources.

Instructions

Discuss fully the accounting treatment and disclosures that should be accorded the casualty and related contingent losses in the financial statements dated December 31, 2012.

CA13-6 (Loss Contingency) Presented below is a note disclosure for Matsui Corporation.

Litigation and Environmental: The Company has been notified, or is a named or a potentially responsible party in a number of governmental (federal, state and local) and private actions associated with environmental matters, such as those relating to hazardous wastes, including certain sites which are on the United States EPA National Priorities List (“Superfund”). These actions seek clean-up costs, penalties and/or damages for personal injury or to property or natural resources.

In 2012, the Company recorded a pre-tax charge of $56,229,000, included in the “Other expense (income)—net” caption of the Company’s consolidated income statements, as an additional provision for environmental matters. These expenditures are expected to take place over the next several years and are indicative of the Company’s commitment to improve and maintain the environment in which it operates. At December 31, 2012, environmental accruals amounted to $69,931,000, of which $61,535,000 are considered noncurrent and are included in the “Deferred credits and other liabilities” caption of the Company’s consolidated balance sheets.

While it is impossible at this time to determine with certainty the ultimate outcome of environmental matters, it is management’s opinion, based in part on the advice of independent counsel (after taking into account accruals and insurance coverage applicable to such actions) that when the costs are finally determined they will not have a material adverse effect on the financial position of the Company.
768 Chapter 13 Current Liabilities and Contingencies

Instructions
Answer the following questions.

(a) What conditions must exist before a loss contingency can be recorded in the accounts?
(b) Suppose that Matsui Corporation could not reasonably estimate the amount of the loss, although it could establish with a high degree of probability the minimum and maximum loss possible. How should this information be reported in the financial statements?
(c) If the amount of the loss is uncertain, how would the loss contingency be reported in the financial statements?

CA13-7 (Warranties and Loss Contingencies) The following two independent situations involve loss contingencies.

Part 1
Benson Company sells two products, Grey and Yellow. Each carries a one-year warranty.

1. Product Grey—Product warranty costs, based on past experience, will normally be 1% of sales.
2. Product Yellow—Product warranty costs cannot be reasonably estimated because this is a new product line. However, the chief engineer believes that product warranty costs are likely to be incurred.

Instructions
How should Benson report the estimated product warranty costs for each of the two types of merchandise above? Discuss the rationale for your answer. Do not discuss disclosures that should be made in Benson’s financial statements or notes.

Part 2
Constantine Company is being sued for $4,000,000 for an injury caused to a child as a result of alleged negligence while the child was visiting the Constantine Company plant in March 2012. The suit was filed in July 2012. Constantine’s lawyer states that it is probable that Constantine will lose the suit and be found liable for a judgment costing anywhere from $400,000 to $2,000,000. However, the lawyer states that the most probable judgment is $1,000,000.

Instructions
How should Constantine report the suit in its 2012 financial statements? Discuss the rationale for your answer. Include in your answer disclosures, if any, that should be made in Constantine’s financial statements or notes.

(AICPA adapted)

CA13-8 (Warranties) The Dotson Company, owner of Bleacher Mall, charges Rich Clothing Store a rental fee of $600 per month plus 5% of yearly profits over $500,000. Matt Rich, the owner of the store, directs his accountant, Ron Hamilton, to increase the estimate of bad debt expense and warranty costs in order to keep profits at $475,000.

Instructions
Answer the following questions.

(a) Should Hamilton follow his boss’s directive?
(b) Who is harmed if the estimates are increased?
(c) Is Matt Rich’s directive ethical?

USING YOUR JUDGMENT

FINANCIAL REPORTING

Financial Reporting Problem
The Procter & Gamble Company (P&G)
The financial statements of P&G are presented in Appendix 5B or can be accessed at the book’s companion website, www.wiley.com/college/kieso.

Instructions
Refer to these financial statements and the accompanying notes to answer the following questions.
(a) What was P&G’s 2009 short-term debt and related weighted-average interest rate on this debt?
(b) What was P&G’s 2009 working capital, acid-test ratio, and current ratio? Comment on P&G’s liquidity.
(c) What types of commitments and contingencies has P&G’s reported in its financial statements? What is management’s reaction to these contingencies?

**Comparative Analysis Case**

**The Coca-Cola Company and PepsiCo, Inc.**

**Instructions**

Go to the book’s companion website and use information found there to answer the following questions related to The Coca-Cola Company and PepsiCo, Inc.

(a) How much working capital do each of these companies have at the end of 2009?
(b) Compute both company’s (a) current cash debt coverage ratio, (b) cash debt coverage ratio, (c) current ratio, (d) acid-test ratio, (e) receivable turnover ratio and (f) inventory turnover ratio for 2009. Comment on each company’s overall liquidity.
(c) In PepsiCo’s financial statements, it reports in the long-term debt section “short-term borrowings, reclassified.” How can short-term borrowings be classified as long-term debt?
(d) What types of loss or gain contingencies do these two companies have at the end of 2009?

**Financial Statement Analysis Cases**

**Case 1 Northland Cranberries**

Despite being a publicly traded company only since 1987, Northland Cranberries of Wisconsin Rapids, Wisconsin, is one of the world’s largest cranberry growers. During its short life as a publicly traded corporation, it has engaged in an aggressive growth strategy. As a consequence, the company has taken on significant amounts of both short-term and long-term debt. The following information is taken from recent annual reports of the company.

**Northland Cranberries**

<table>
<thead>
<tr>
<th></th>
<th>Current Year</th>
<th>Prior Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets</td>
<td>$ 6,745,759</td>
<td>$ 5,998,054</td>
</tr>
<tr>
<td>Total assets</td>
<td>107,744,751</td>
<td>83,074,339</td>
</tr>
<tr>
<td>Current liabilities</td>
<td>10,168,685</td>
<td>4,484,687</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>73,118,204</td>
<td>49,948,787</td>
</tr>
<tr>
<td>Shareholders’ equity</td>
<td>34,626,547</td>
<td>33,125,552</td>
</tr>
<tr>
<td>Net sales</td>
<td>21,783,966</td>
<td>18,051,355</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>13,057,275</td>
<td>8,751,220</td>
</tr>
<tr>
<td>Interest expense</td>
<td>3,654,006</td>
<td>2,393,792</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>1,051,000</td>
<td>1,917,000</td>
</tr>
<tr>
<td>Net income</td>
<td>1,581,707</td>
<td>2,942,954</td>
</tr>
</tbody>
</table>

**Instructions**

(a) Evaluate the company’s liquidity by calculating and analyzing working capital and the current ratio.

(b) The discussion of the company’s liquidity, shown on page 770, was provided by the company in the Management Discussion and Analysis section of the company’s annual report. Comment on whether you agree with management’s statements, and what might be done to remedy the situation.
Chapter 13 Current Liabilities and Contingencies

The lower comparative current ratio in the current year was due to $3 million of short-term borrowing then outstanding which was incurred to fund the Yellow River Marsh acquisitions last year. As a result of the extreme seasonality of its business, the company does not believe that its current ratio or its underlying stated working capital at the current, fiscal year-end is a meaningful indication of the Company’s liquidity. As of March 31 of each fiscal year, the Company has historically carried no significant amounts of inventories and by such date all of the Company’s accounts receivable from its crop sold for processing under the supply agreements have been paid in cash, with the resulting cash received from such payments used to reduce indebtedness. The Company utilizes its revolving bank credit facility, together with cash generated from operations, to fund its working capital requirements throughout its growing season.

Case 2 Mohican Company

Presented below is the current liabilities section and related note of Mohican Company.

<table>
<thead>
<tr>
<th>Current Liabilities</th>
<th>Current Year</th>
<th>Prior Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current portion of long-term debt</td>
<td>15,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Short-term debt</td>
<td>2,668</td>
<td>405</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>29,495</td>
<td>42,427</td>
</tr>
<tr>
<td>Accrued warranty</td>
<td>16,843</td>
<td>16,741</td>
</tr>
<tr>
<td>Accrued marketing programs</td>
<td>17,512</td>
<td>16,585</td>
</tr>
<tr>
<td>Other accrued liabilities</td>
<td>35,653</td>
<td>33,290</td>
</tr>
<tr>
<td>Accrued and deferred income taxes</td>
<td>16,206</td>
<td>17,348</td>
</tr>
<tr>
<td>Total current liabilities</td>
<td>133,377</td>
<td>136,796</td>
</tr>
</tbody>
</table>

Notes to Consolidated Financial Statements

Note 1 (in part): Summary of Significant Accounting Policies and Related Data

Accrued Warranty The company provides an accrual for future warranty costs based upon the relationship of prior years’ sales to actual warranty costs.

Instructions

Answer the following questions.

(a) What is the difference between the cash basis and the accrual basis of accounting for warranty costs?

(b) Under what circumstance, if any, would it be appropriate for Mohican Company to recognize deferred revenue on warranty contracts?

(c) If Mohican Company recognized deferred revenue on warranty contracts, how would it recognize this revenue in subsequent periods?

Case 3 BOP Clothing Co.

As discussed in the chapter, an important consideration in evaluating current liabilities is a company’s operating cycle. The operating cycle is the average time required to go from cash to cash in generating revenue. To determine the length of the operating cycle, analysts use two measures: the average days to sell inventory (inventory days) and the average days to collect receivables (receivable days). The inventory-days computation measures the average number of days it takes to move an item from raw materials or purchase to final sale (from the day it comes in the company’s door to the point it is converted to cash or an account receivable). The receivable-days computation measures the average number of days it takes to collect an account.

Most businesses must then determine how to finance the period of time when the liquid assets are tied up in inventory and accounts receivable. To determine how much to finance, companies first determine accounts payable days—how long it takes to pay creditors. Accounts payable days measures the number of days it takes to pay a supplier invoice. Consider the following operating cycle worksheet for BOP Clothing Co.
These data indicate that BOP has reduced its overall operating cycle (to 261.5 days) as well as the number of days to be financed with sources of funds other than accounts payable (from 78 to 63 days). Most businesses cannot finance the operating cycle with accounts payable financing alone, so working capital financing, usually short-term interest-bearing loans, is needed to cover the shortfall. In this case, BOP would need to borrow less money to finance its operating cycle in 2012 than in 2011.

Instructions
(a) Use the BOP analysis to briefly discuss how the operating cycle data relate to the amount of working capital and the current and acid-test ratios.

(b) Select two other real companies that are in the same industry and complete the operating cycle worksheet on the previous page, along with the working capital and ratio analysis. Briefly summarize and interpret the results. To simplify the analysis, you may use ending balances to compute turnover ratios.

Accounting, Analysis, and Principles
(Note: For any part of this problem requiring an interest or discount rate, use 10 percent.)

YellowCard Company manufactures accessories for iPods. It had the following selected transactions during 2012.

1. YellowCard provides a 2-year warranty on its docking stations, which it began selling in 2012. During 2012, YellowCard spent $6,000 servicing warranty claims. At year-end, YellowCard estimates that an additional $45,000 will be spent in the future to service warranties related to 2012 sales.

2. YellowCard has a $200,000 loan outstanding from First Trust Corp. The loan is set to mature on February 28, 2013. For several years, First Trust has agreed to extend the loan, as long as YellowCard makes all its quarterly interest payments (interest is due on the last days of each February, May, August, and November) and maintains an acid-test ratio (also called “quick ratio”) of at least 1.25. First Trust has provided YellowCard a “commitment letter” indicating that First Trust will extend the loan another 12 months, providing YellowCard makes the interest payment due on March 31.
772 Chapter 13 Current Liabilities and Contingencies

3. During 2011, YellowCard constructed a small manufacturing facility specifically to manufacture one particular accessory. YellowCard paid the construction contractor $5,000,000 cash (which was the total contract price) and placed the facility into service on January 1, 2012. Because of technological change, YellowCard anticipates that the manufacturing facility will be useful for no more than 10 years. The local government where the facility is located required that, at the end of the 10-year period, YellowCard remediate the facility so that it can be used as a community center. YellowCard estimates the cost of remediation to be $500,000.

Accounting
Prepare all 2012 journal entries relating to (a) YellowCard’s warranties, (b) YellowCard’s loan from First Trust Corp., and (c) the new manufacturing facility YellowCard opened on January 1, 2012.

Analysis
Describe how the transactions above affect ratios that might be used to assess YellowCard’s liquidity. How important is the commitment letter that YellowCard has from First Trust Corp. to these ratios?

Principles
YellowCard is contemplating offering an extended warranty. If customers pay an additional $50 at the time of product purchase, YellowCard would extend the warranty an additional two years. Would the extended warranty meet the definition of a liability under current generally accepted accounting principles? Briefly explain?

BRIDGE TO THE PROFESSION

Professional Research: FASB Codification
Pleasant Co. manufactures specialty bike accessories. The company is known for product quality, and it has offered one of the best warranties in the industry on its higher-priced products—a lifetime guarantee, performing all the warranty work in its own shops. The warranty on these products is included in the sales price.

Due to the recent introduction and growth in sales of some products targeted to the low-price market, Pleasant is considering partnering with another company to do the warranty work on this line of products, if customers purchase a service contract at the time of original product purchase. Pleasant has called you to advise the company on the accounting for this new warranty arrangement.

Instructions
If your school has a subscription to the FASB Codification, go to http://aaahq.org/asclogin.cfm to log in and prepare responses to the following. Provide Codification references for your responses.
(a) Identify the accounting literature that addresses the accounting for the type of separately priced warranty that Pleasant is considering.
(b) When are warranty contracts considered separately priced?
(c) What are incremental direct acquisition costs and how should they be treated?

Professional Simulation
In this simulation, you are asked to address questions related to the accounting for current liabilities. Prepare responses to all parts.
Alex Rodriguez Inc., a publishing company, is preparing its December 31, 2012, financial statements and must determine the proper accounting treatment for the following situations.

(a) Rodriguez sells subscriptions to several magazines for a 1-year, 2-year, or 3-year period. Cash receipts from subscribers are credited to magazine subscriptions collected in advance, and this account had a balance of $2,300,000 at December 31, 2012. Outstanding subscriptions at December 31, 2012, expire as follows.

During 2013—$600,000
During 2014— 500,000
During 2015— 800,000

(b) On January 2, 2012, Rodriguez discontinued collision, fire, and theft coverage on its delivery vehicles and became self-insured for these risks. Actual losses of $50,000 during 2012 were charged to delivery expense. The 2011 premium for the discontinued coverage amounted to $80,000, and the controller wants to set up a reserve for self-insurance by a debit to delivery expense of $30,000 and a credit to the reserve for self-insurance of $30,000.

(c) A suit for breach of contract seeking damages of $1,000,000 was filed by an author against Rodriguez on July 1, 2012. The company’s legal counsel believes that an unfavorable outcome is probable. A reasonable estimate of the court’s award to the plaintiff is in the range between $300,000 and $700,000. No amount within this range is a better estimate of potential damages than any other amount.

(d) The following items are listed as liabilities on the balance sheet on December 31, 2012.

Accounts payable $ 420,000
Notes payable 750,000
Bonds payable 2,250,000

The accounts payable represent obligations to suppliers that were due in January 2013. The notes payable mature on various dates during 2013. The bonds payable mature on July 1, 2013.

For situations (a), (b), and (c), prepare the journal entry that should be recorded as of December 31, 2012.

Prepare a brief memorandum explaining the general rule for classifying a liability as current or noncurrent. Explain the conditions under which notes payable might be classified as current or noncurrent.

IFRS and GAAP have similar definitions for liabilities. IFRS related to reporting and recognition of liabilities is found in IAS 1 (“Presentation of Financial Statements”) and IAS 37 (“Provisions, Contingent Liabilities, and Contingent Assets”).

**RELEVANT FACTS**

- Similar to U.S. practice, IFRS requires that companies present current and non-current liabilities on the face of the statement of financial position (balance sheet), with current liabilities generally presented in order of liquidity. However, many companies using IFRS present non-current liabilities before current liabilities on the statement of financial position.
The basic definition of a liability under GAAP and IFRS is very similar. In a more technical way, liabilities are defined by the IASB as a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. Liabilities may be legally enforceable via a contract or law but need not be; that is, they can arise due to normal business practices or customs.

IFRS requires that companies classify liabilities as current or non-current on the face of the statement of financial position (balance sheet), except in industries where a presentation based on liquidity would be considered to provide more useful information (such as financial institutions).

Under IFRS, the measurement of a provision related to a contingency is based on the best estimate of the expenditure required to settle the obligation. If a range of estimates is predicted and no amount in the range is more likely than any other amount in the range, the “mid-point” of the range is used to measure the liability. In GAAP, the minimum amount in a range is used.

Both IFRS and GAAP prohibit the recognition of liabilities for future losses. However, IFRS permits recognition of a restructuring liability, once a company has committed to a restructuring plan. GAAP has additional criteria (i.e., related to communicating the plan to employees) before a restructuring liability can be established.

IFRS and GAAP are similar in the treatment of asset retirement obligations (AROs). However, the recognition criteria for an ARO are more stringent under GAAP: The ARO is not recognized unless there is a present legal obligation and the fair value of the obligation can be reasonably estimated.

Under IFRS, short-term obligations expected to be refinanced can be classified as non-current if the refinancing is completed by the financial statement date. GAAP uses the date the financial statements are issued.

IFRS uses the term provisions to refer to estimated liabilities. Under IFRS, contingencies are not recorded but are often disclosed. The accounting for provisions under IFRS and estimated liabilities under GAAP are very similar.

GAAP uses the term “contingency” in a different way than IFRS. Contingent liabilities are not recognized in the financial statements under IFRS, whereas under GAAP a contingent liability is sometimes recognized.

### ABOUT THE NUMBERS

**Refinancing Criteria**

The IASB has developed criteria for determining the circumstances under which short-term obligations may be properly excluded from current liabilities. Specifically, a company can exclude a short-term obligation from current liabilities if both of the following conditions are met:

1. It must intend to refinance the obligation on a long-term basis; and
2. It must have an unconditional right to defer settlement of the liability for at least 12 months after the reporting date.

Intention to refinance on a long-term basis means that the company intends to refinance the short-term obligation so that it will not require the use of working capital during the ensuing fiscal year (or operating cycle, if longer). Entering into a financing arrangement that clearly permits the company to refinance the debt on a long-term basis on terms that are readily determinable before the next reporting date is one way to satisfy the second condition. In addition, the fact that a company has the right to refinance at any time and intends to do so permits the company to classify the liability as non-current.
To illustrate, assume that Haddad Company provides the following information related to its note payable.

- Issued note payable of $3,000,000 on November 30, 2011, due on February 28, 2012. Haddad’s reporting date is December 31, 2011.
- Haddad intends to extend the maturity date of the loan (refinance the loan) to June 30, 2013.
- The necessary paperwork to refinance the loan is completed on January 15, 2012. Haddad did not have an unconditional right to defer settlement of the obligation at December 31, 2011.

A graphical representation of the refinancing events is provided in Illustration IFRS13-1.

<table>
<thead>
<tr>
<th>Liability of $3,000,000</th>
<th>Refinancing completed</th>
<th>Liability due for payment</th>
<th>Statements authorized for issuance</th>
</tr>
</thead>
</table>

In this case, Haddad must classify its note payable as a current liability because the refinancing was not completed by December 31, 2011, the financial reporting date. Only if the refinancing was completed before December 31, 2011, can Haddad classify the note obligation as non-current. The rationale: Refinancing a liability after the statement of financial position date does not affect the liquidity or solvency at the date of the statement of financial position, the reporting of which should reflect contractual agreements in force on that date.

What happens if Haddad has both the intention and the discretion (within the loan agreement) to refinance or roll over its $3,000,000 note payable to June 30, 2013? In this case, Haddad should classify the note payable as non-current because it has the ability to defer the payment to June 30, 2013.

**Provisions**

As indicated in the Relevant Facts section, a provision is a liability of uncertain timing or amount (sometimes referred to as an estimated liability). Provisions are very common and may be reported either as current or non-current depending on the date of expected payment. Common types of provisions are obligations related to litigation, warranties or product guarantees, business restructurings, and environmental damage.

The difference between a provision and other liabilities (such as accounts or notes payable, salaries payable, and dividends payable) is that a provision has greater uncertainty about the timing or amount of the future expenditure required to settle the obligation. For example, when Siemens AG reports an accounts payable, there is an invoice or formal agreement as to the existence and the amount of the liability. Similarly, when Siemens accrues interest payable, the timing and the amount are known.\(^{21}\)

**Recognition of a Provision**

Companies accrue an expense and related liability for a provision only if the following three conditions are met:

1. A company has a present obligation (legal or constructive) as a result of a past event;

\(^{21}\)The distinction is important because provisions are subject to disclosure requirements that do not apply to other types of payables.
2. It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and.

3. A reliable estimate can be made of the amount of the obligation.

If any of these three conditions are not met, no provision is recognized.

In applying the first condition, the past event (often referred to as the past obligatory event) must have occurred. In applying the second condition, the term probable is defined as “more likely than not to occur.” This phrase is interpreted to mean the probability of occurrence is greater than 50 percent. If the probability is 50 percent or less, the provision is not recognized.

**Measurement of Provisions**

How does a company like Toyota, for example, determine the amount to report for its warranty cost on its automobiles? How does a company like Carrefour determine its liability for customer refunds? Or, how does Novartis determine the amount to report for a lawsuit that it probably will lose? And, how does a company like Total S.A. determine the amount to report as a provision for its remediation costs related to environmental clean-up?

IFRS provides an answer: The amount recognized should be the best estimate of the expenditure required to settle the present obligation. Best estimate represents the amount that a company would pay to settle the obligation at the statement of financial position date.

**Measurement Examples.** In determining the best estimate, the management of a company must use judgment, based on past or similar transactions, discussions with experts, and any other pertinent information. Here is how this judgment might be used in three different types of situations to arrive at best estimate:

- **Toyota warranties.** Toyota sells many cars and must make an estimate of the number of warranty repairs and related costs it will incur. Because it is dealing with a large population of automobiles, it is often best to weight all possible outcomes by associated probabilities. For example, it might determine that 80 percent of its cars will not have any warranty cost, 12 percent will have substantial costs, and 8 percent will have a much smaller cost. In this case, by weighting all the possible outcomes by their associated probabilities, Toyota arrives at an expected value for its warranty liability.

- **Carrefour refunds.** Carrefour sells many items at varying selling prices. Refunds to customers for products sold may be viewed as a continuous range of refunds, with each point in the range having the same probability of occurrence. In this case, the midpoint in the range can be used as the basis for measuring the amount of the refunds.

- **Novartis lawsuit.** Large companies like Novartis are involved in numerous litigation issues related to their products. Where a single obligation such as a lawsuit is being measured, the most likely outcome of the lawsuit may be the best estimate of the liability.

**Common Types of Provisions**

Here are some common areas for which provisions may be recognized in the financial statements:

1. Lawsuits
2. Warranties
3. Premiums
4. Environmental
5. Onerous contracts
6. Restructuring

IFRS accounting guidance is similar to GAAP for these items. Although companies generally report only one current and one non-current amount for provisions in the statement of financial position, IFRS also requires extensive disclosure related to provisions in the notes to the
financial statements. Companies do not record or report in the notes to the financial statements general risk contingencies inherent in business operations (e.g., the possibility of war, strike, uninsurable catastrophes, or a business recession).

**Onerous Contract Provisions**

Sometimes, companies have what are referred to as **onerous contracts**. These contracts are ones in which “the unavoidable costs of meeting the obligations exceed the economic benefits expected to be received.” An example of an onerous contract is a loss recognized on unfavorable non-cancelable purchase commitments related to inventory items.

To illustrate another situation, assume that Sumart Sports operates profitably in a factory that it has leased and on which it pays monthly rentals. Sumart decides to relocate its operations to another facility. However, the lease on the old facility continues for the next three years. Unfortunately, Sumart cannot cancel the lease nor will it be able to sublet the factory to another party. The expected costs to satisfy this onerous contract are $200,000. In this case, Sumart makes the following entry.

\[
\begin{align*}
\text{Loss on Lease Contract} & \quad 200,000 \\
\text{Lease Contract Liability} & \quad 200,000
\end{align*}
\]

The expected costs should reflect the least net cost of exiting from the contract, which is the lower of (1) the cost of fulfilling the contract, or (2) the compensation or penalties arising from failure to fulfill the contract.

**Contingencies**

In a general sense, all provisions are contingent because they are uncertain in timing or amount. However, IFRS uses the term “contingent” for liabilities and assets that are not recognized in the financial statements.

**Contingent Liabilities**

Contingent liabilities are not recognized in the financial statements because they are (1) a possible obligation (not yet confirmed as a present obligation), (2) a present obligation for which it is not probable that payment will be made, or (3) a present obligation for which a reliable estimate of the obligation cannot be made. Examples of contingent liabilities are:

- A lawsuit in which it is only possible that the company might lose.
- A guarantee related to collectability of a receivable.

Illustration IFRS13-2 presents the general guidelines for the accounting and reporting of contingent liabilities.

<table>
<thead>
<tr>
<th>Outcome</th>
<th>Probability*</th>
<th>Accounting Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Virtually certain</td>
<td>At least 90%</td>
<td>Report as liability (provision).</td>
</tr>
<tr>
<td>Probable (more likely than not)</td>
<td>51–89% probable</td>
<td>Report as liability (provision).</td>
</tr>
<tr>
<td>Possible but not probable</td>
<td>5–50%</td>
<td>Disclosure required.</td>
</tr>
<tr>
<td>Remote</td>
<td>Less than 5%</td>
<td>No disclosure required.</td>
</tr>
</tbody>
</table>

*In practice, the percentages for virtually certain and remote may deviate from those presented here.

Unless the possibility of any outflow in settlement is remote, companies should disclose the contingent liability at the end of the reporting period, providing a brief description of the nature of the contingent liability and, where practicable:

1. An estimate of its financial effect;
2. An indication of the uncertainties relating to the amount or timing of any outflow; and
3. The possibility of any reimbursement.
Chapter 13 Current Liabilities and Contingencies

Contingent Assets

A contingent asset is a possible asset that arises from past events and whose existence will be confirmed by the occurrence or non-occurrence of uncertain future events not wholly within the control of the company. Typical contingent assets are:

1. Possible receipts of monies from gifts, donations, bonuses.
2. Possible refunds from the government in tax disputes.
3. Pending court cases with a probable favorable outcome.

Contingent assets are not recognized on the statement of financial position. If realization of the contingent asset is virtually certain, it is no longer considered a contingent asset and is recognized as an asset. Virtually certain is generally interpreted to be at least a probability of 90 percent or more.

The general rules related to contingent assets are presented in Illustration IFRS13-3.

![ILLUSTRATION IFRS13-3 Contingent Asset Guidelines](chart)

<table>
<thead>
<tr>
<th>Outcome</th>
<th>Probability*</th>
<th>Accounting Treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Virtually certain</td>
<td>At least 90% probable</td>
<td>Report as asset (no longer contingent).</td>
</tr>
<tr>
<td>Probable (more likely than not)</td>
<td>51–90% probable</td>
<td>Disclose.</td>
</tr>
<tr>
<td>Possible but not probable</td>
<td>5–50%</td>
<td>No disclosure required.</td>
</tr>
<tr>
<td>Remote</td>
<td>Less than 5%</td>
<td>No disclosure required.</td>
</tr>
</tbody>
</table>

*In practice, the percentages for virtually certain and remote may deviate from those presented here.

Contingent assets are disclosed when an inflow of economic benefits is considered more likely than not to occur (greater than 50 percent). However, it is important that disclosures for contingent assets avoid giving misleading indications of the likelihood of income arising. As a result, it is not surprising that the thresholds for allowing recognition of contingent assets are more stringent relative to those for liabilities.

What might be an example of a contingent asset that becomes an asset to be recorded? To illustrate, assume that Marcus Realty leases a property to Marks and Spencer plc (M&S). The contract is non-cancelable for five years. On December 1, 2011, before the end of the contract, M&S withdraws from the contract and is required to pay £245,000 as a penalty. At the time M&S cancels the contract, a receivable and related income should be reported by Marcus. The disclosure includes the nature and, where practicable, the estimated financial effects of the asset.

IFRS SELF-TEST QUESTIONS

1. The presentation of current and non-current liabilities in the statement of financial position (balance sheet):
   (a) is shown only on GAAP financial statements.**AU/Pub: change ok?**
   (b) is shown on both a GAAP and an IFRS statement of financial position.
   (c) is always shown with current liabilities reported first in an IFRS statement of financial position.
   (d) includes contingent liabilities under IFRS.

2. In accounting for short-term debt expected to be refinanced to long-term debt:
   (a) GAAP uses the authorization date to determine classification of short-term debt to be refinanced.
   (b) IFRS uses the authorization date to determine classification of short-term debt to be refinanced.
   (c) IFRS uses the financial statement date to determine classification of short-term debt to be refinanced.
   (d) GAAP uses the date of issue, but only for secured debt, to determine classification of short-term debt to be refinanced.
3. Under IFRS, a provision is the same as:
   (a) a contingent liability.
   (b) an estimated liability.
   (c) a contingent gain.
   (d) None of the above.

4. A typical provision is:
   (a) bonds payable.
   (b) cash.
   (c) a warranty liability.
   (d) accounts payable.

5. In determining the amount of a provision, a company using IFRS should generally measure:
   (a) using the midpoint of the range between the lowest possible loss and the highest possible loss.
   (b) using the minimum amount of the loss in the range.
   (c) using the best estimate of the amount of the loss expected to occur.
   (d) using the maximum amount of the loss in the range.

IFRS CONCEPTS AND APPLICATION

IFRS13-1 Under what conditions should a short-term obligation be excluded from current liabilities?

IFRS13-2 What evidence is necessary to demonstrate the ability to defer settlement of short-term debt?

IFRS13-3 Define a provision, and give three examples of a provision.

IFRS13-4 Under what conditions should a provision be recorded?

IFRS13-5 Distinguish between a current liability, such as accounts payable, and a provision.

IFRS13-6 What is an onerous contract? Give two examples of an onerous contract.

IFRS13-7 On December 31, 2012, Alexander Company had $1,200,000 of short-term debt in the form of notes payable due February 2, 2013. On January 21, 2013, the company issued 25,000 ordinary shares for $36 per share, receiving $900,000 proceeds after brokerage fees and other costs of issuance. On February 2, 2013, the proceeds from the share sale, supplemented by an additional $300,000 cash, are used to liquidate the $1,200,000 debt. The December 31, 2012, statement of financial position is authorized for issue on February 23, 2013.

Instructions
Show how the $1,200,000 of short-term debt should be presented on the December 31, 2012, statement of financial position.

IFRS13-8 Presented below are two different situations related to Mckee Corporation debt obligations. Mckee’s next financial reporting date is December 31, 2012. The financial statements are authorized for issuance on March 1, 2013.

1. Mckee has a long-term obligation of $400,000, which is maturing over 4 years in the amount of $100,000 per year. The obligation is dated November 1, 2012, and the first maturity date is November 1, 2013.


Instructions
Indicate how each of these debt obligations is reported on Mckee’s statement of financial position on December 31, 2012.
The following situations relate to Bolivia Company.

1. Bolivia provides a warranty with all its products it sells. It estimates that it will sell 1,000,000 units of its product for the year ended December 31, 2012, and that its total revenue for the product will be $100,000,000. It also estimates that 60% of the product will have no defects, 30% will have major defects, and 10% will have minor defects. The cost of a minor defect is estimated to be $5 for each product sold, and the cost for a major defect cost is $15. The company also estimates that the minimum amount of warranty expense will be $2,000,000 and the maximum will be $10,000,000.

2. Bolivia is involved in a tax dispute with the tax authorities. The most likely outcome of this dispute is that Bolivia will lose and have to pay $400,000. The minimum it will lose is $20,000 and the maximum is $2,500,000.

Instructions
Prepare the journal entry to record provisions, if any, for Bolivia at December 31, 2012.

Kobayashi Corporation reports in the current liability section of its statement of financial position at December 31, 2012 (its year-end), short-term obligations of $15,000,000, which includes the current portion of 12% long-term debt in the amount of $10,000,000 (matures in March 2013). Management has stated its intention to refinance the 12% debt whereby no portion of it will mature during 2013. The date of issuance of the financial statements is March 25, 2013.

Instructions
(a) Is management’s intent enough to support long-term classification of the obligation in this situation?
(b) Assume that Kobayashi Corporation issues $13,000,000 of 10-year debentures to the public in January 2013 and that management intends to use the proceeds to liquidate the $10,000,000 debt maturing in March 2013. Furthermore, assume that the debt maturing in March 2013 is paid from these proceeds prior to the authorization to issue the financial statements. Will this have any impact on the statement of financial position classification at December 31, 2012? Explain your answer.
(c) Assume that Kobayashi Corporation issues ordinary shares to the public in January and that management intends to entirely liquidate the $10,000,000 debt maturing in March 2013 with the proceeds of this equity securities issue. In light of these events, should the $10,000,000 debt maturing in March 2013 be included in current liabilities at December 31, 2012?

Professional Research
Hincapie Co. manufactures specialty bike accessories. The company is most well known for its product quality, and it has offered one of the best warranties in the industry on its higher-priced products—a lifetime guarantee. The warranty on these products is included in the sales price. Hincapie has a contract with a service company, which performs all warranty work on Hincapie products. Under the contract, Hincapie guarantees the service company at least $200,000 of warranty work for each year of the 3-year contract.

The recent economic recession has been hard on Hincapie’s business, and sales for its higher-end products have been especially adversely impacted. As a result, Hincapie is planning to restructure its high-quality lines by moving manufacturing for those products into one of its other factories, shutting down assembly lines, and terminating workers. In order to keep some workers on-board, Hincapie plans to bring all warranty work in-house. It can terminate the current warranty contract by making a one-time termination payment of $75,000.
The restructuring plans have been discussed by management during November 2010; they plan to get approval from the board of directors at the December board meeting and execute the restructuring in early 2011. Given the company’s past success, the accounting for restructuring activities has never come up. Hincapie would like you to do some research on how it should account for this restructuring according to IFRS.

Instructions

Access the IFRS authoritative literature at the IASB website (http://eifrs.iasb.org/). When you have accessed the documents, you can use the search tool in your Internet browser to respond to the following questions. (Provide paragraph citations.)

(a) Identify the accounting literature that addresses the accounting for the various costs that will be incurred in the restructuring.

(b) Advise Hincapie on the restructuring costs. When should Hincapie recognize liabilities arising from the restructuring? What costs can be included? What costs are excluded?

(c) Does Hincapie have a liability related to the service contract? Explain. If Hincapie has a liability, at what amount should it be recorded?

International Financial Reporting Problem:

Marks and Spencer plc


Instructions

Refer to M&S’s financial statements and the accompanying notes to answer the following questions.

(a) What was M&S’s 2010 short-term debt and related weighted-average interest rate on this debt?

(b) What was M&S’s 2010 working capital, acid-test ratio, and current ratio? Comment on M&S’s liquidity.

(c) What types of commitments and contingencies has M&S reported in its financial statements?

ANSWERS TO IFRS SELF-TEST QUESTIONS

1. b 2. c 3. b 4. c 5. c

Remember to check the book’s companion website to find additional resources for this chapter.